The Southland Corporation | 1997 Annual Report

Company Profile

The convenience retailing industry began in 1927 when a Southland Ice Company employee met the needs of his customers by selling bread, milk and eggs from the steps of his ice dock. The name 7-Eleven originated in 1946 when the stores were open from 7 a.m. until 11 p.m. Today, approximately 95 percent of all 7-Eleven stores in the United States and Canada are open 24 hours a day. With 17,104 convenience stores worldwide (see inside back cover for listing of stores by country and by state), 7-Eleven is the premier name in the convenience retailing industry and the largest operator, franchisor and licensor of convenience stores in the world.

IYG Holding Company (IYG) owns 65 percent of Southland's common stock. IYG is 51-percent owned by Ito-Yokado Co., Ltd., the seventh-largest retailer in the world, and 49-percent owned by Seven-Eleven Japan Co., Ltd., the longtime 7-Eleven licensee for Japan.

Southland's common stock is traded on The Nasdaq Stock Market under the ticker symbol SLCM.

Corporate Mission

The Southland Corporation strives to maximize the long-term market value of shareholder equity. Our heritage is 7-Eleven. Its profitable growth and increasing dominance in convenience retailing will remain the core of our existence. We will be successful to the degree that we fulfill the needs of our customers. "What they want, when and where they want it" in a manner that provides added value, engenders loyalty and promotes a lasting relationship. To ensure Southland's continued excellence, we must retain the flexibility to anticipate opportunities and to master all forms of competitive challenge.

Our most important resource is people. Southland excels because of the quality, motivation and loyalty of every member of the Southland family. We are committed to innovation through participative involvement, and to fostering an environment of trust, respect and shared values.

As a responsible corporate citizen, Southland will conduct its business in an ethical manner with the highest integrity, while contributing to the quality of life in the communities it serves.

The ultimate measure of Southland's success is the optimal utilization of our collective resources and the perpetuation of a culture that is distinguished for its clarity of purpose, emphasis on individual responsibility and standards of excellence.

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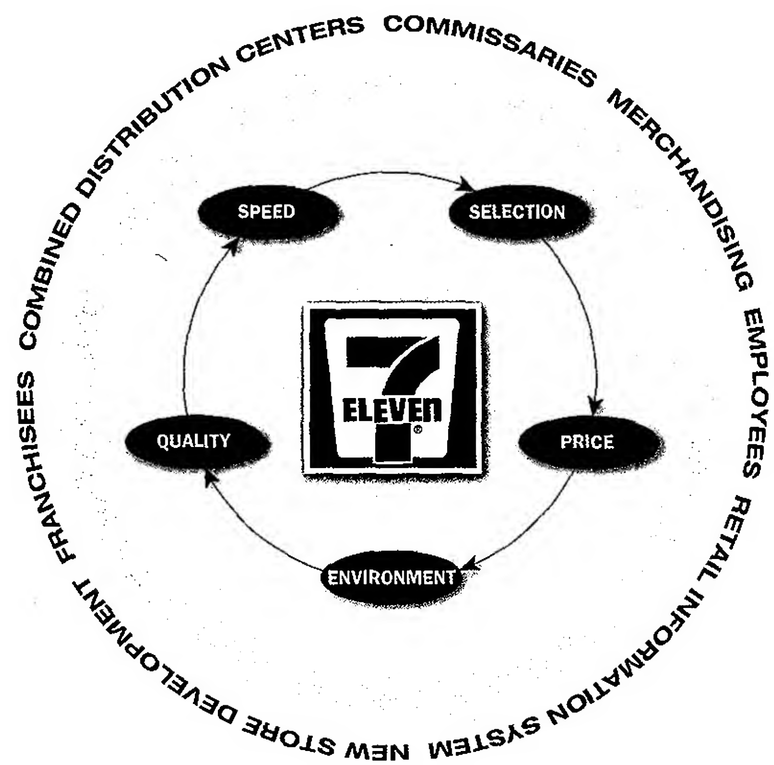
Southland pioneered the convenience store industry over 70 years ago with the simple idea of saving people a little time and our business concept still reflects that goal — to provide customers an ever-changing selection of the quality products and services they want, at fair everyday prices, and give them a speedy transaction in a clean, safe and friendly environment. Although the tactics have changed over time, the fundamental principles have not.



Today, 7-Eleven is focused on redefining and enhancing convenience through strategic initiatives designed to take advantage of new technologies and merchandising processes, but which remain based on the five components of its business concept. As a result of these initiatives, along with the dedication of its employees, franchisees and licensees worldwide, 7-Eleven continues to be the premier name in convenience retailing.

(Dollars in Millions, Except Per-Share Data)

Years Ended December 31	1997	1996	1995	1994	1993
For the Year:					
Net Sales	$ 6,971.1	$ 6,868.9	$ 6,745.8	$ 6,684.5	$ 6,744.3
Other Income	89.4	86.4	78.5	74.6	71.3
Total Revenues	7,060.6	6,955.3	6,824.3	6,759.1	6,815.6
Net Earnings (1)(3)	70.0	89.5	270.8	92.0	71.2
Net Earnings Per Common Share: (1)(3)					
Basic	.17	.22	.66	.22	.17
Diluted	.16	.20	.65	.22	.17
Payments for Purchase of Property and Equipment	232.5	194.4	192.2	171.6	195.1
Interest Expense, Net (1)	90.1	90.2	85.6	95.0	81.8
At Year-End:					
Common Shares Outstanding (in thousands)	409,923	409,923	409,923	409,923	409,923
Number of Stores Operated or Franchised by Southland in U.S. and Canada	5,423	5,422	5,424	5,630	5,796
Number of Stores Operated by Licensees or Affiliates in U.S. and Overseas	11,681	10,892	9,961	9,067	8,360
Shareholders of Record	2,714	2,834	3,097	3,060	3,130
Number of Employees (Full-time and Part-time)	30,323	29,532	30,523	30,417	32,406
Shareholders' Equity (Deficit) (1)	$ (721.5)	$ (789.0)	$ (880.8)	$ (1,157.2)	$ (1,248.4)
Book Value Per Common Share (1)	(1.76)	(1.92)	(2.15)	(2.82)	(3.05)
Total Assets	2,090.1	2,039.1	2,081.1	2,000.6	1,990.0

(1) *The Company is required to prepare its financial statements since completing the 1991 Restructuring in accordance with Statement of Financial Accounting Standards No. 15 (SFAS No. 15). Under SFAS No. 15, the liability for the Company's restructured public debt as recorded on the balance sheet includes all future undiscounted cash payments, both principal and interest. For that reason, no interest expense will be recognized over the life of these securities, although the interest payments are tax deductible. The liability is reduced by the amount of the interest payments at the time they are disbursed. Those cash interest payments, which are paid semiannually, totaled $56 million in 1993, $35 million in both 1994 and 1995 and $22 million in both 1996 and 1997. In November 1995, a portion of the restructured public debt was refinanced, thus reducing the restructured public debt's cash interest payments to $22 million annually beginning in 1996 through 2002, after which payments will decline because of bond maturities.*

(2) *Includes completed closings and dispositions, as well as losses expected in the near future.*

(3) *Net earnings for 1993 through 1995 include the following*	1995	1994	1993
Loss on non-store assets sold	—	—	$ (10.8)
Gain on debt redemption	$ 103.2	—	99.0
Tax benefit from reduction of valuation allowance	84.3	$ 30.0	—
Cumulative effect of accounting change for postemployment benefits	—	—	(16.5)
Severance and related costs	(13.4)	(7.4)	(7.2)
Loss on closings and dispositions of properties (2)	—	(3.7)	(48.2)

To Our Shareholders and Bondholders

1997 was both an exciting and challenging year for 7-Eleven. It was exciting because we began field-testing the scanning and ordering phase of our state-of-the-art retail information system, added daily delivery of "fresh-sensitive" products to another 800 stores, opened 61 stores and ended the last half of the year with the largest same-store real merchandise sales improvement in three years. It was challenging because the increase in gross profits from higher merchandise sales was not sufficient to offset lower gas gross profits due to difficult market conditions, costs associated with our investment in long-term, strategic initiatives and rising labor costs. The net result, coupled with a non-recurring benefit from a tax settlement in 1996, was a decline of nearly $20 million in net income. However, we firmly believe that continued focus on implementing the strategic initiatives we have underway is in the best interests of both our shareholders and 7-Eleven. In the near term, we simply must achieve higher merchandise sales increases, lower product costs and better manage expenses to significantly improve bottom-line results.

In order to help accomplish these objectives, during the year we made both organizational and process changes designed to bring fresh perspectives, enthusiasm and renewed creativity to our merchandising approach. 7-Eleven same-store merchandise sales rose for the fourth consecutive year and, during the last half of 1997, merchandise sales increases consistently outpaced the grocery industry, with three of the last four months of the year having sales increases of over 3 percent. We are encouraged that this trend has continued into the early part of 1998, with January merchandise sales increasing over 4 percent.

We also are aggressively attacking rising expenses in two ways. First, we are re-examining all store activities to simplify or eliminate those that do not directly serve the customer. For example, we expect to greatly reduce paperwork, freeing managers and sales associates to focus on being in-stock on items customers want and to explain the benefits of 7-Eleven products. Second, we are concentrating on reducing store labor costs by emphasizing job assignment and forecasting techniques designed to optimize the number of labor hours needed for the essential tasks and traffic levels in each store, by time and day of the week. In addition, several of our major vendors are helping us reduce labor costs by rescheduling their deliveries to off-peak hours. Not only does this better utilize store labor during the slower, early-morning shifts, it reduces parking lot congestion for 7-Eleven customers.

Despite these challenges, the future of both 7-Eleven and the convenience store industry is brighter than ever. Customers' workweeks are lengthening — even the traditional "lunch hour" is disappearing — and the need for convenience has never been greater. 7-Eleven's business concept — providing an ever-changing, broad **selection** of the **quality** products and services that customers want, at fair everyday **prices,** in a quick, **speedy** transaction and in a clean, safe and friendly **environment** — directly addresses these needs. Our entire organization is focused on implementing the strategies and tactics designed to promote this business concept and eliminating any activities that are not consistent with our mission.

Retail Information System

We are now in the pilot stage of the scanning and ordering phase of 7-Eleven's proprietary, state-of-the-art retail information system (RIS). RIS provides significantly more functionality than just scanning; in fact, it is designed to help improve each store's merchandise assortment by organizing the most current sales data for analysis, which enables proper ordering. Correct ordering for fast-moving items requires accurate sales information and decision-relevant data to assure customer satisfaction by being in-stock on high-potential items. Our focus on being in-stock was recently confirmed by an industry study which estimated that the average c-store is out of stock on nearly 10 percent of items, equating to lost sales of 3 to 6 percent, or $1.5 to $3 billion industry-wide.

Franchisees and store managers believe they know what sells in their individual stores, but it's more difficult to see the opportunity loss in what's not selling. RIS will give 7-Eleven operators the ability to base merchandising decisions, such as deleting slow-moving items to make room for exciting new product introductions, on actual customer behavior rather than instinct or emotion. We plan to begin full roll-out of RIS in mid-1998, with approximately 3,000 stores scheduled to receive the system by year-end.

Merchandising

While customers want convenience, they also expect fair prices. Southland meets regularly with its largest vendors to drive out non-essential costs along the entire supply chain. By working with our vendors, Southland receives lower costs and can offer 7-Eleven customers better prices while maintaining margins.

7-Eleven customers also want to find products that are new to the market, or new to convenience stores. In mid-1997, 7-Eleven introduced its proprietary Burger Big Bite™, a hamburger shaped like a hot dog, that is easier to eat on the go. 7-Eleven sold nearly 7 million units by year-end and has already introduced the even more popular Bacon Cheeseburger Big Bite™. In early 1998, 7-Eleven introduced the world's first automated Financial Services Centers in 37 Austin, Texas, stores. These new centers initially offer check cashing, money transfers, bill payments and other services 24 hours a day and have the potential for additional services in the future. Southland plans to begin national roll-out of these new centers following successful pilot tests. New products and services such as these differentiate 7-Eleven from other convenience stores.

Commissary/Bakery/Combined Distribution Centers

Customers want fresh, delicious products that they can eat on the go. Deli Central commissaries, operated by skilled third parties for 7-Eleven, have the ability to provide our customers with an unmatched variety of high-quality foods. Most of the ingredients for each day's production are delivered to the commissary that day, ensuring that 7-Eleven products are the freshest possible. Preparing Deli Central foods centrally by food service professionals allows a higher level of quality, consistency and variety system-wide for 7-Eleven than can be achieved with in-store production or other direct-store delivery programs.

We also have worked closely with third-party bakery operators to create proprietary pastry recipes specifically for 7-Eleven. Sales of fresh-bakery products rose nearly $12 million in 1997, all in areas served by World Ovens bakeries.

In 1997, consolidated daily-delivery service, fresh foods and bakery products were made available to another 800 stores. At year-end, over half of Southland's stores had these strategic advantages. In addition to Deli Central and World Ovens foods, the combined distribution centers also allow other products, like bread and milk, to be measurably fresher than typically found in other retail stores. Another important advantage of the proprietary delivery system is that it gives 7-Eleven stores access to non-traditional convenience-store products where distribution in small numbers to a large base of stores is otherwise not available.

Store Development

Southland opened 61 stores during 1997, the most in any single year in nearly a decade, and began construction on 41 more. More importantly, our new store development efforts are gaining momentum and we expect to build at least 150 new stores in 1998. We also plan to target selected acquisitions in 7-Eleven markets that can be served by the combined distribution system and, in February, we announced the purchase of 23 stores in the Midwest, the first acquisition in nearly a decade.

1998

While we have taken the first steps toward again growing the business, we intend to accelerate the pace of change in 1998. Recent improvements in merchandise sales trends, combined with the number of new stores we plan to add this year, will provide the momentum necessary to continue our path toward sustainable and profitable growth. Our challenge for 1998 is clear. We must continue building an infrastructure to provide products and services that will differentiate 7-Eleven from the competition while concurrently pursuing the aggressive reduction of non-essential costs to offset the start-up expenses associated with our strategic initiatives. The long-term result will be a 7-Eleven that can profitably serve the convenience customer in ways our competitors cannot easily replicate.

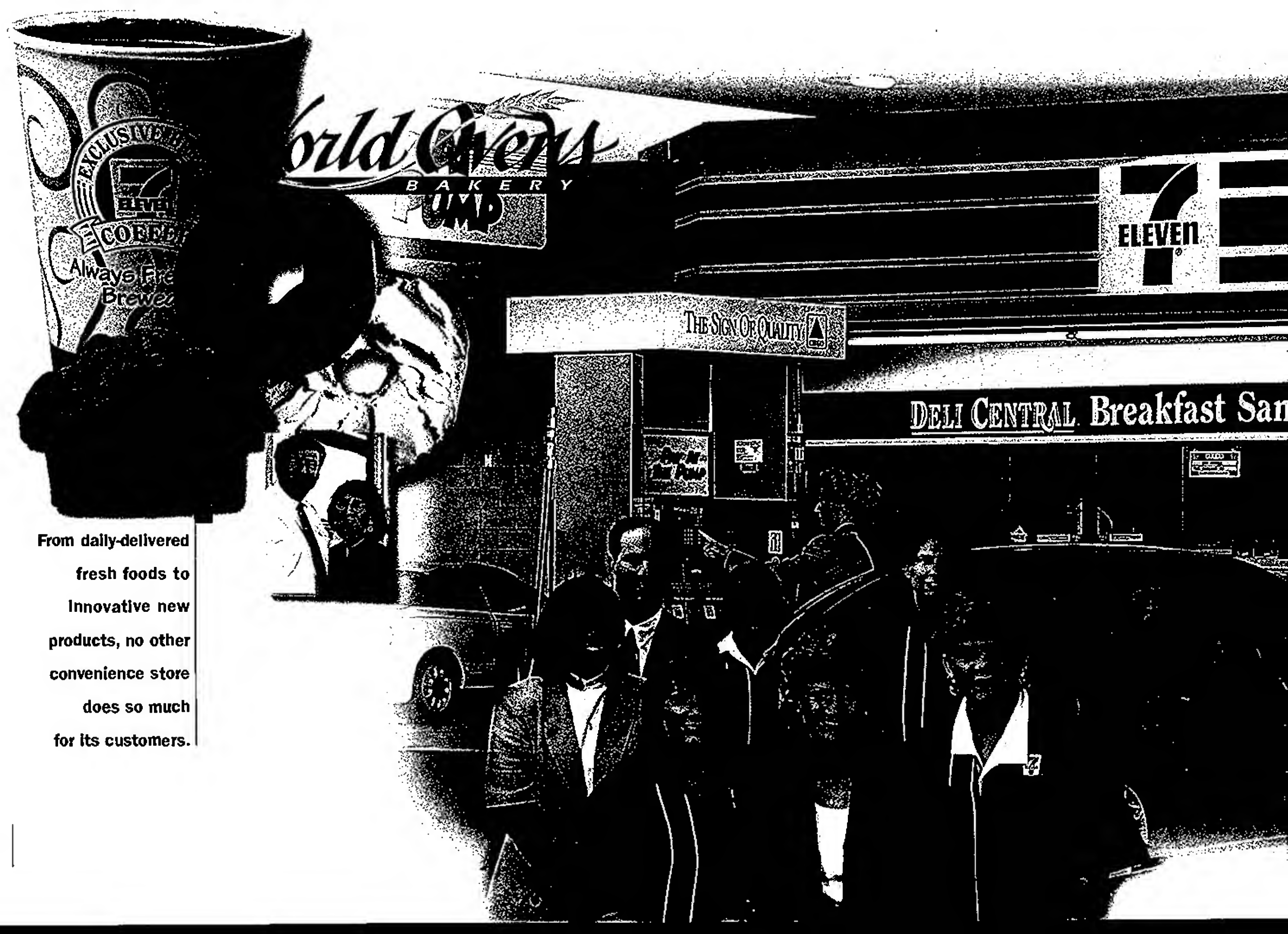
I want to thank all 7-Eleven employees and franchisees for working to exceed customer expectations, our suppliers and strategic partners for working to develop products, services and systems that will truly differentiate 7-Eleven from its competitors and Southland's majority owners and other stakeholders for their continued support. These collective efforts ensure that 7-Eleven will continue to be the premier name in convenience retailing.

Clark Matthews

Clark J. Matthews, II
President and Chief Executive Officer
March 12, 1998

With over 17,100 stores, 7-Eleven is the largest and most recognized convenience store chain in the world. Of these, 5,423 stores are operated or franchised by Southland in the United States and Canada. Franchisees operate 53 percent of those stores and their sales are included in the company's revenues. Area licensees and affiliates operate 472 U.S. stores, as well as 11,209 in 18 other countries and two U.S. territories; royalties from these stores are included in Southland's Other Income. 7-Eleven's $7.1 billion in revenues (excluding licensees and affiliates) makes it the eighth-largest food and drug retailer and the largest independent convenience store company in the United States.

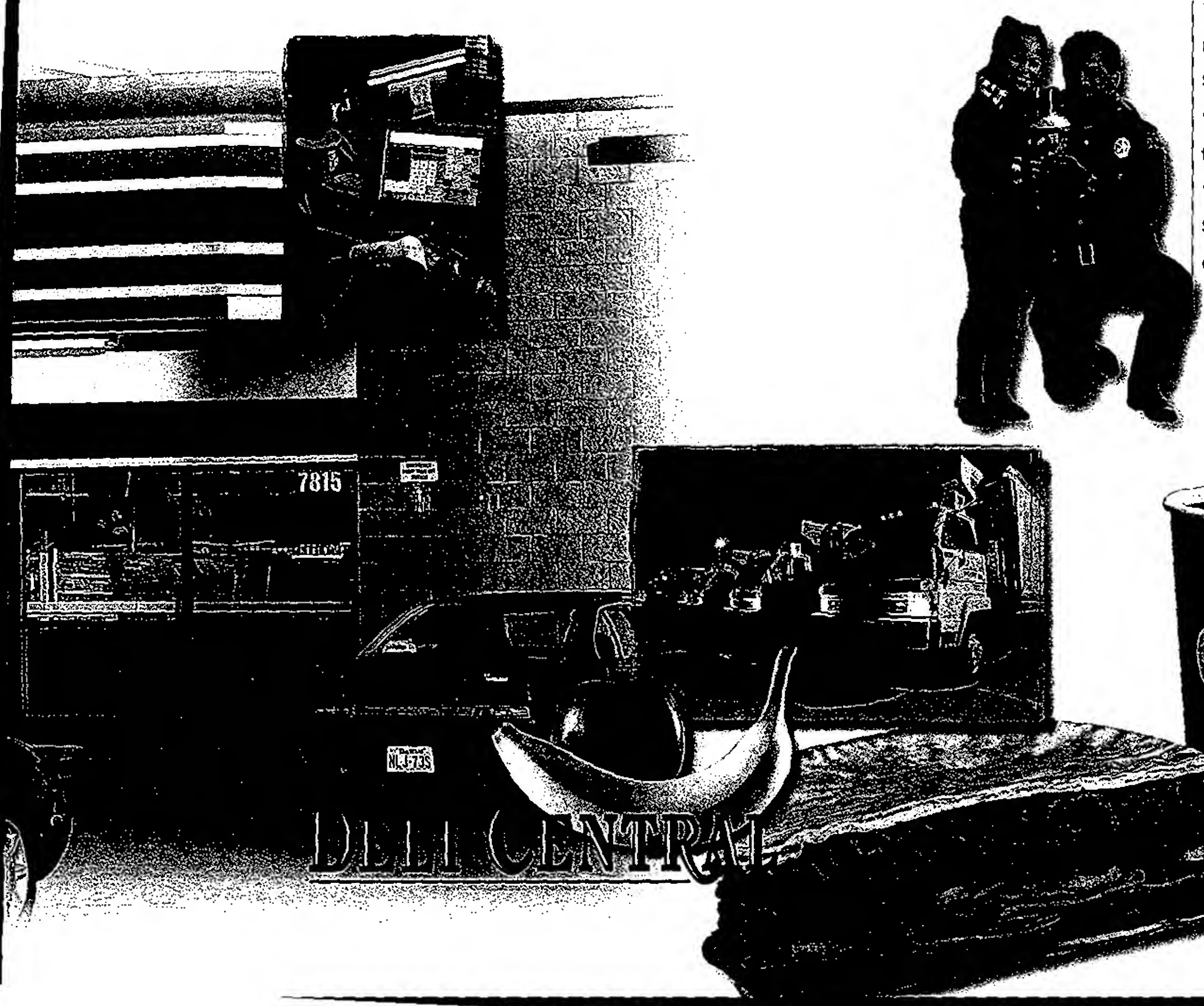
Southland pioneered the convenience store industry over 70 years ago when an employee began selling bread, milk and eggs from his ice dock as a convenience to his customers. People began requesting that he add other products and, before long, sales of the new items became a business unto themselves. From that simple opportunity, the convenience store industry was born, and, although the product mix continues to change, the fundamental idea of giving people "what they want, when and where they want it" has not. Today, with product life cycles shortening and customers' increasing demands for quality products at fair prices, Southland continues to look for new items and services that make life easier and better for our customers.



From daily-delivered fresh foods to innovative new products, no other convenience store does so much for its customers.

7-Eleven is developing a leading-edge approach that will allow it to satisfy customer demands in a way that is different from other retailers. The infrastructure necessary to provide such differentiation includes a fresh-food program that offers a level of quality and consistency unmatched in the convenience store industry. It also includes a distribution system that supplies those fresh foods on a daily basis to each 7-Eleven and provides access to products where traditional distribution economics are unfavorable. Finally, a new, proprietary retail information system (RIS) that ties everything together assists store operators in always being in-stock and allows each store to tailor its product selection for its own customers. This approach is not easily replicated and has already proven highly successful for Seven-Eleven Japan, that country's most profitable retailer.

Southland ended 1997 with encouraging improvement in sales and a renewed focus on the strategic initiatives that will distinguish 7-Eleven from other convenience stores, and provide the foundation for profitable, sustainable sales increases. Southland is committed to achieving appropriate returns for its shareholders, helping 7-Eleven franchisees grow their business, providing a rewarding workplace for our employees and being a caring corporate citizen in the communities we serve.



7-Eleven contributed nearly one million Slurpees' through "Operation Chill." In this program, police "ticket" kids with free Slurpee coupons for doing good deeds.

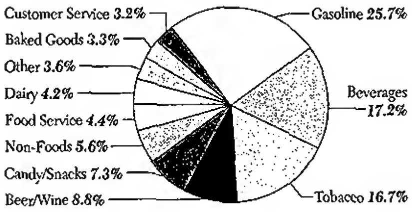

Ordering is the most important job at 7-Eleven. Having the right products in stock is the key to customer satisfaction.
order
sales
ordering decisions.
yze
Do customers want this item?
What is (and isn't) selling?
products
DELETE ITEMS
AMOUNT OR FUNCTION
Enter
Clear
Cash
BIG GULP
Lay's
Sour Cream & Onion

Retail Information System

Retailing is evolving from an art to a science, and with modern technology, businesses are better able to understand their sales. For most retailers, the advantages of scanning are measured in terms of accounting and labor efficiencies. While these are important, 7-Eleven believes scanning's greatest value is in ordering, product assortment and merchandising. Through the real-time collection and analysis of sales data, each store operator will be able to make more timely and informed merchandising decisions on every item, every day. The system is fully integrated with vendors and corporate merchandising to receive product and other information that will simplify the ordering process. In mid-1997, Southland began field tests of this phase of RIS.

Ordering

A recent industry study confirmed that customers will quickly take their business to alternate store if they don't find what they want. Staying in stock on fast-moving items is the number-one priority for 7-Eleven. RIS organizes information about past sales, local events and weather to help store operators more accurately forecast unit sales of each item, ensuring that they order enough to meet demand.



Southland Convenience Store Sales by Category

Most retailers have to accommodate vendors' delivery schedules, which means that ordering and receiving those products is often inefficient from the stores' perspective. Southland is working with its vendors to reschedule deliveries, allowing store operators to order similar products, like all soft drinks, at the same time and receive deliveries on the same day making ordering and stocking easier. Moving deliveries to the stores' least busy time relieves parking lot congestion during the day and more effectively utilizes labor during those times.

Product Selection

Each year thousands of new products enter the marketplace, and many have high potential for 7-Eleven. However, in order to make room for those products in a 2,400 square-foot store, others must be removed. RIS provides information to help identify slow-moving items so they can be replaced by those with higher potential. Its sophisticated analytical tools even help choose from among the many new products by organizing category product offerings by type, package and sales potential. This type of analysis will reveal opportunities to fill in product assortment gaps and expand "facings" of the fastest selling items.

One of the first stores to receive RIS reviewed its sales of juices and waters and believed there was an opportunity to expand this line; however, doing so would mean reducing the number of vault doors dedicated to beer — certainly a break with tradition in c-stores. The entire analysis took less than two hours and, after the staff made the change, total units sold from the vault increased nearly 9 percent, with beer down only marginally. Perhaps most significantly, the system gave immediate feedback to the store manager, providing the opportunity for learning. Prior to RIS, sales information came after month-end and the opportunity to recognize the effect of changes was lost.

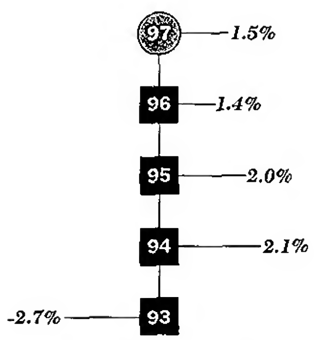
The key to the full use of RIS is that all analysis and decision-making will be done in the store. By combining sales and product assortment data with personal knowledge of their customers and their neighborhoods, store operators will be able to make better product selection, ordering and merchandising decisions for their stores.

New Products

Consumers are constantly looking for products that are new and interesting, and 7-Eleven is sourcing and receiving at an unprecedented rate. These products give customers a reason to bypass a less appealing competitor in favor of 7-Eleven. Because of their novelty, margins on new products are frequently higher than the average.

Manufacturers know that 7-Eleven can provide instant visibility in more than 17,000 stores world wide, and Southland is often able to negotiate exclusive rights to product introductions for a period of time. Exclusives are important because customers learn to come to 7-Eleven in order to find these products and, by the time the products are widely available, customers are already in the habit of buying them from 7-Eleven. Examples of some of the new products added in 1997 are Ben & Jerry's® Peanut Butter & Jelly Ice Cream Bar and a ready-to-drink Kool-Aid® beverage called "Splash™," a product developed for 7-Eleven.

Continuing the tradition of innovation, 7-Eleven recently introduced pre-paid cellular phone cards. Industry sources suggest that one-third of people who would like cellular phone service don't have it due to credit problems or an aversion to monthly fees. Working with third parties, 7-Eleven offered these new phone cards to make cellular service accessible and much more affordable for its customers.



Same-Store Merchandise Sales

7-Eleven sold nearly 100 million hot dogs in 1997. The hamburger is the most popular fast-food item in the U.S. So why not combine the two? In May, 7-Eleven introduced the Burger Big Bite™, a hamburger shaped like a hot dog. This unique product is easier to eat on the go than a regular burger and is cooked on existing roller grills. Customers loved the idea, and this product quickly became a significant part of an already successful grill business. The success of the Burger Big Bite has given rise to the Bacon Cheeseburger Big Bite™, a delicious new product which is proving even more popular.

7-Eleven, one of the top coffee retailers in the U.S., built on that strength in 1997 by adding hot cappuccino machines. In 1998, 7-Eleven plans to capitalize on a growing trend by introducing "Cafe Cooler™," a high-quality semi-frozen coffee drink, in cappuccino and mocha flavors. Both of these offerings will expand coffee customers' usage beyond the morning.

Advertising

7-Eleven's advertising this year featured the popular "Oh Thank Heaven™" theme and developed the message with our "First/Best/Only" strategy. The commercials focused on products that are first available in 7-Eleven (the new Kool-Aid Splash drink), for which 7-Eleven is recognized by customers as the best (7-Eleven's exclusive blend of coffee) or that are only available in 7-Eleven (Slurpee®). This advertising helps create differentiation by highlighting the products and services that make 7-Eleven special in the marketplace.

Southland recently unveiled the world's first automated Financial Services Centers in Austin, Texas. These centers provide 24-hour check cashing, money transfers, bill payment and other financial services.

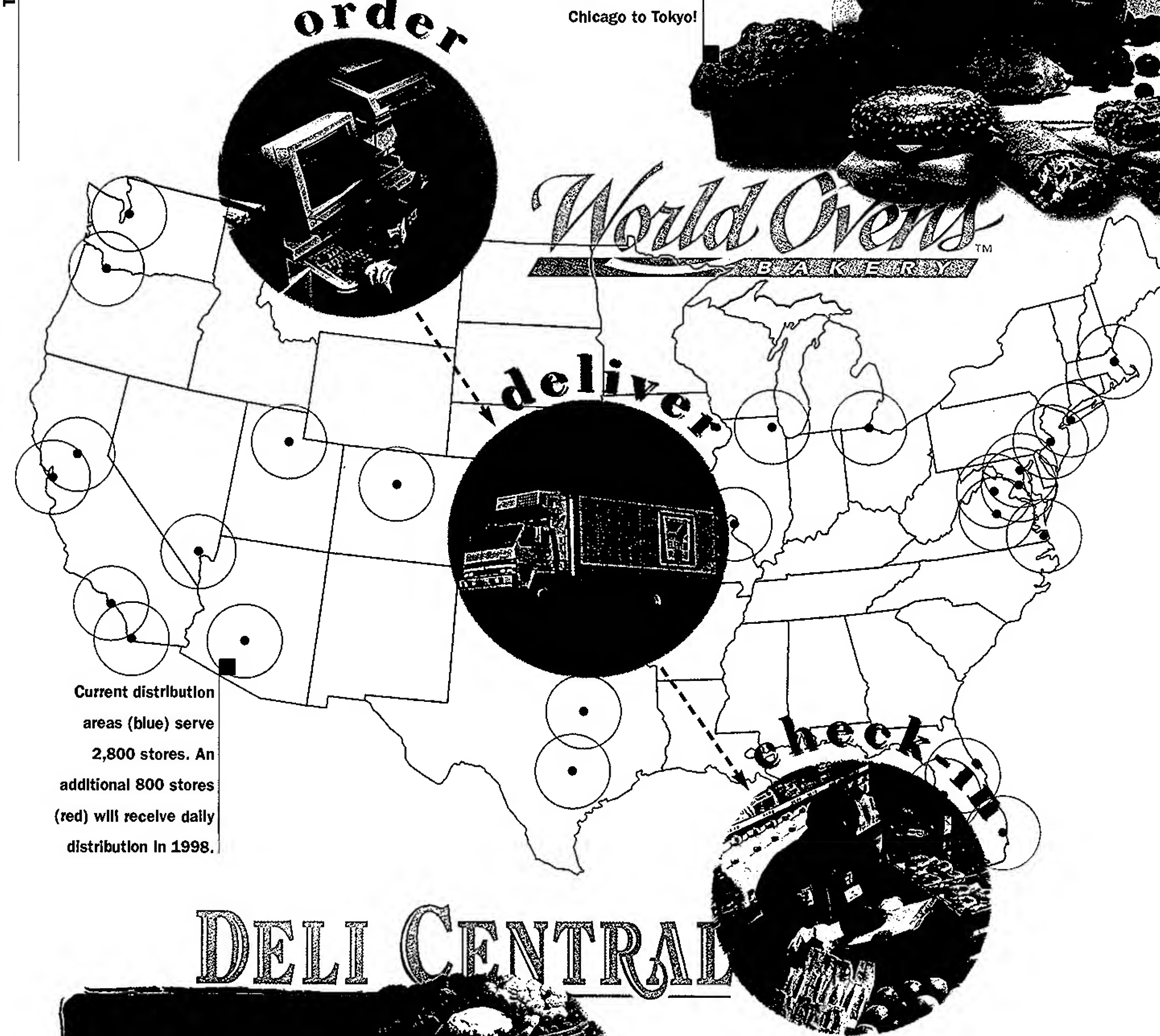
The new Bacon Cheeseburger Big Bite complements our quality hot dog program. In 1998, 7-Eleven expects to sell its one billionth Oscar Mayer grill product.

What a year for Slurpee! The summer Brainfreeze™ straw promotion helped increase sales 17 percent.

Capitalizing on the popularity of hot drinks, 7-Eleven sold 55 million cups of cappuccino and hot chocolate.

If you lined up all the World Ovens items made for 7-Eleven in 1997, they would extend from Chicago to Tokyo!

World Ovens™ BAKERY



Current distribution areas (blue) serve 2,800 stores. An additional 800 stores (red) will receive daily distribution in 1998.

DELI CENTRAL

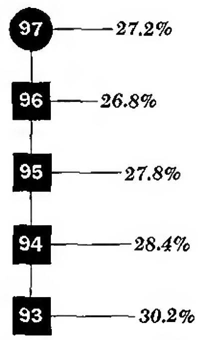
7-Eleven continues to expand its line of daily-delivered fresh foods with the introduction of the Super Big Sub in 1998.

Commissary/Bakery

The challenge of breaking into the crowded world of fresh foods is the same as establishing any new business — being better, fresher and a truly unique alternative. The commissaries that serve 7-Eleven provide three important advantages: freshness, quality and variety. This system gives 7-Eleven delicious, new fresh-food products that are rapidly gaining popularity with customers.

Producing products centrally allows the greatest degree of freshness because the commissaries receive the stores' orders by mid-morning and buy most of the ingredients for each day's production that day. Proprietary bread recipes are baked to order and the Oscar Mayer® ham and Louis Rich® turkey in 7-Eleven sandwiches come fresh, never frozen, every day.

On-site cooking, the very strength of typical fast-food restaurants, is itself a limitation. The restaurants' menu is limited by the production talent of each kitchen. The skilled commissary operators that serve 7-Eleven ensure consistent quality and can produce a diverse menu of products, such as the Super Big Sub™ or a teriyaki rice bowl. 7-Eleven is currently working with experienced food consultants who have proven success in several food concepts. To capitalize on the nearly two million customers that come into 7-Eleven every morning, they are developing and testing a more complete breakfast program. These products are expected to be launched in all commissary-served stores by the summer of 1998.



Operating, Selling, General and Administrative Expense as a Percent of Sales

World Ovens bakeries provide our stores with fresh, delicious donuts and pastries in the variety and exact quantity that each store's customers want. In addition to breakfast items for the morning commuter rush, the bakeries provide fresh products, such as gourmet pretzels and cookies, for afternoon snacks. By year-end 1997, daily delivery of fresh foods and bakery products was available to over half the 7-Eleven stores in the United States.

Combined Distribution Centers

In addition to providing daily delivery of fresh foods, the combined distribution centers also allow 7-Eleven to receive other "time-sensitive" products more frequently. Convenience stores using direct-store delivery typically get milk, bread,and other items two to three times per week. 7-Eleven's distribution system allows each store to order and receive fresh milk and bread every day. In addition to delivering the freshest products seven days a week, this system provides access to popular products not traditionally found in convenience stores due to distribution hurdles from smaller companies that cannot efficiently deliver to several hundred stores in limited amounts.

During 1997, the rollout of the distribution system continued with 800 additional stores having the capability of receiving daily-delivered items. Southland will expand daily delivery of fresh foods in 1998 by adding another 800 stores, mostly in franchised markets. The distribution operations in these new markets will initially use extra capacity in existing facilities. By not waiting for new facilities, Southland can roll out the fresh-food program more quickly. Southland expects that about half of the new areas will have fully dedicated facilities by the end of 1998. All combined distribution centers are owned by third parties who are experts in their fields.

Gasoline

With annual sales of nearly $1.8 billion in over 2,000 stores, gasoline is the single-largest product category at 7-Eleven. Although the gasoline business is known for its cyclical nature, 7-Eleven's proactive approach to managing retail price changes and a favorable supply arrangement with Citgo Petroleum has somewhat mitigated this volatility of earnings.

Customers now expect gas retailers to have many fueling spaces and the ability to pay at the pump. New 7-Eleven stores selling gas have large, modern facilities with at least 12 fueling locations and credit-card readers on the pumps. This allows gas customers to get in and out quickly by paying outside, and shortens the line for merchandise customers inside the store. Incremental gas gallons from these dispensers and higher merchandise sales from better in-store service more than offset potential lost impulse sales to customers paying outside.

1998 is a key year in the federal program of underground storage tank maintenance. By year-end, all gasoline locations must be in compliance with strict equipment standards or discontinue selling gasoline. Southland began bringing its stores up to these standards in 1993 and will be in full compliance at year-end. Due to the high cost of upgrading gas facilities, a significant number of competitors' stores are expected to close rather than make the investment.

Pay-at-the-pump dispensers allow motorists to be on their way quickly.

Store Operations

Without a doubt, 7-Eleven's most important strategic advantage is the dedication of its store operators. While Southland is developing tools, such as RIS, to provide better decision-making information, it is ultimately the store operators who make the actual decisions on order quantities and product assortment. RIS can tell them whether sales of specific products rose or fell, but personal knowledge of their customers and surrounding neighborhood is the key to understanding the reasons why. These two important pieces of information will enable store operators to make the appropriate merchandising decisions necessary to satisfy their customers and consistently achieve profitable sales increases.

Franchisees operate over half of Southland's domestic stores and their entrepreneurial spirit is one of 7-Eleven's greatest assets. The benefit of franchising any business is the power of shared learning and access to proprietary products, services and support. Southland is committed to growing the value of each 7-Eleven franchise by supporting the improvement in profitable sales.

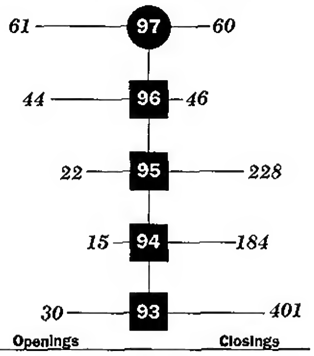
Southland believes 1998 will be an important year in its relationship with 7-Eleven franchisees and communication will play a key role. The anticipated settlement of two class-action lawsuits brought by a small number of franchisees will allow the entire 7-Eleven team to turn its focus on increasing the profitability of each and every store. Through various forums, Southland is committed to listening and responding to the needs of its franchisees in major aspects of managing their business in the current and future retailing environment.

The Domenos — Matt, Herb, Gerty and Tim — have been franchisees for nearly 30 years. Their seven stores produced sales of over $12 million in 1997.

7-Eleven meets regularly with franchisees to ensure good communication.

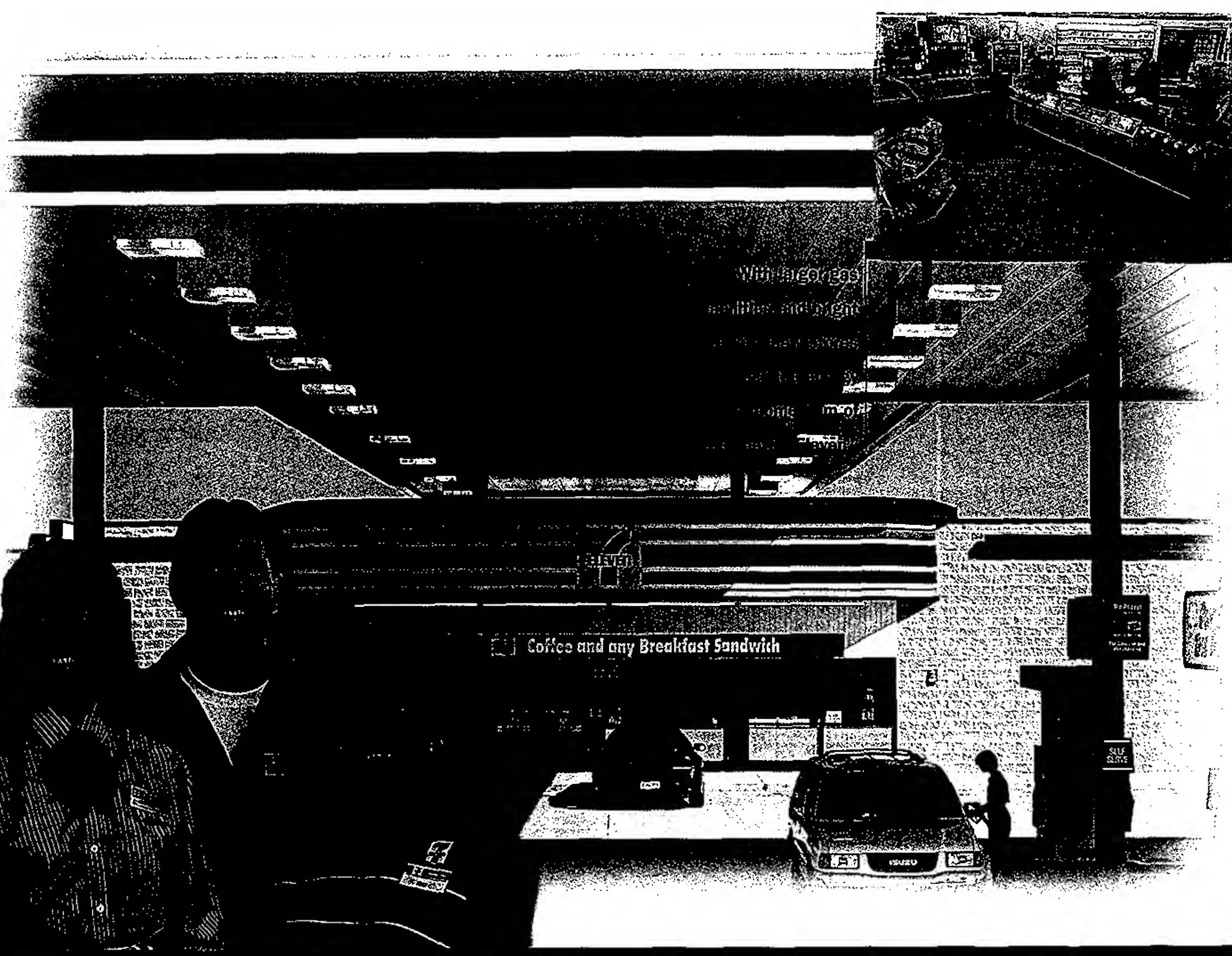
During 1997, Southland opened 61 stores and started construction on another 41. With the new store development process gaining momentum, Southland expects to open 150 stores in 1998, with that pace accelerating in subsequent years. These stores are typically on high-traffic corners and most have larger gas facilities. Southland is especially targeting areas that already have a strong 7-Eleven presence, and can contribute to market economies of scale associated with its various initiatives and advertising. In early 1998, Southland agreed to purchase 23 stores in the Midwest, strengthening 7-Eleven's presence there and increasing the efficiencies of the distribution center, commissary and bakery in that area.

Currently, the majority of new sites are in the fastest-growing areas and, as a result, sales in new stores quickly match the division averages in both merchandise and gas gallons. Southland anticipates that, as their trade areas mature, sales in these stores will be among the highest in the company.



Store Unit Activity
Includes relocation, rebuild and seasonal activity.

In addition to building new stores, Southland is also committed to continually upgrading its existing store base. For example, 7-Eleven worked with a key vendor to develop a new bakery case that organizes all bakery products and displays them more prominently. Tests indicated sales increases of over 20 percent and these cases were added to all stores in areas with World Ovens bakeries. 7-Eleven also tested a new, larger ice cream novelty case that allows access to products from two sides. Novelty sales increased in those stores that received the new case and, by year-end, they were installed in over 2,000 stores.



(Dollars in Millions, Except Per-Share Data)

Years Ended December 31	1997	1996	1995	1994	1993
Net sales	$ 6,971.1	$ 6,868.9	$ 6,745.8	$ 6,684.5	$ 6,744.3
Other income	89.4	86.4	78.5	74.6	71.3
Total revenues	7,060.6	6,955.3	6,824.3	6,759.1	6,815.6
LIFO charge (credit)	0.1	4.7	2.6	3.0	(8.7)
Depreciation and amortization	196.2	185.4	166.4	162.7	154.4
Interest expense, net	90.1	90.2	85.6	95.0	81.8
Earnings (loss) before income taxes, extraordinary items and cumulative effect of accounting changes	115.3	130.8	101.5	73.5	(2.6)
Income taxes (benefit)	45.3	41.3	(66.1)[a]	(18.5)[b]	8.7
Earnings (loss) before extraordinary items and cumulative effect of accounting changes	70.0	89.5	167.6	92.0	(11.3)
Net earnings	70.0	89.5	270.8[c]	92.0	71.2[d]
Earnings (loss) before extraordinary items and cumulative effect of accounting changes per common share:					
Basic	.17	.22	.41	.22	(.03)
Diluted	.16	.20	.40	.22	(.03)
Total assets	2,090.1	2,039.1	2,081.1	2,000.6	1,990.0
Long-term debt, including current portion	1,803.4	1,707.4	1,850.6	2,351.2	2,419.9

(a) *Income taxes (benefit) include an $84.3 million tax benefit from recognition of the remaining portion of the Company's net deferred tax assets as explained in Note 14 to the Consolidated Financial Statements.*
(b) *Income taxes (benefit) include a $30 million tax benefit from recognition of a portion of the Company's net deferred tax assets.*
(c) *Net earnings include an extraordinary gain of $103.2 million on debt redemption as explained in Note 8 to the Consolidated Financial Statements.*
(d) *Net earnings include an extraordinary gain of $99 million on debt redemption and a charge for the cumulative effect of an accounting change for postemployment benefits of $16.5 million.*

Some of the matters discussed in this annual report contain forward-looking statements regarding the Company's future business which are subject to certain risks and uncertainties, including competitive pressures, adverse economic conditions and government regulations. These issues, and other factors which may be identified from time to time in the Company's reports filed with the SEC, could cause actual results to differ materially from those indicated in the forward-looking statements.

Results of Operations

Summary of Results of Operations

The Company's net earnings for the year ended December 31, 1997 were $70.0 million, compared to net earnings of $89.5 million in 1996 and $270.8 million in 1995.

(Dollars in Millions, Except Per-Share Data)

Years Ended December 31	1997	1996	1995
Earnings before income taxes and extraordinary gain	$ 115.3	$ 130.8	$ 101.5
Income tax (expense) benefit	(45.3)	(41.3)	66.1
Extraordinary gain from partial redemption of the Company's 4½% and 5% debentures	—	—	103.2
Net earnings	$ 70.0	$ 89.5	$ 270.8
Net earnings per common share — Basic	$ .17	$ .22	$ .66
Net earnings per common share — Diluted	$ .16	$ .20	$ .65

The decline in the Company's net earnings from the prior year resulted from start-up costs associated with its strategic initiatives, higher per-store labor expense, lower gas gross profits and a benefit from an IRS tax settlement in 1996. Merchandise sales growth over the last half of 1997 offset a portion of these factors.

Management Strategies

Since 1992, the Company has been committed to several key strategies that it believes, over the long term, will provide further differentiation from competitors and allow 7-Eleven to maintain its position as the premier convenience retailer. These strategies include: upgrading the store base; a customer-driven approach to product selection; an everyday-fair-pricing policy on all items; daily delivery of fresh perishable items; introduction of high-quality, ready-to-eat fresh foods; and the implementation of a state-of-the-art retail information system.

Prior to 1997, the Company focused on upgrading its store base, through remodeling existing stores and closing underachieving stores. In late 1996, the Company completed the most extensive remodeling program in its history. Future upgrade programs will focus on retail information systems, food service and other merchandising programs. Beginning in late 1996 and throughout 1997, the Company began to focus its efforts on opening or acquiring new stores. The Company's 10-year decline in operating properties was slowed in 1996 and ended in 1997 with net store growth. Store openings over the last three years totaled 61, 44 and 22 in 1997, 1996 and 1995, respectively. In addition, there were 41 stores under construction at December 31, 1997. In 1998, new store openings are expected to outpace closings, with the expansion occurring in existing markets to support the Company's fresh-food and combined-distribution initiatives. In recent years, the Company has pruned its store base, closing or disposing of those stores that either could not support its strategies, were not expected to achieve an acceptable level of profitability in the future or had leases which expired. As a result, store closings during the past three years totaled 60, 46 and 228 in 1997, 1996 and 1995, respectively. The Company expects to close slightly more stores in 1998 than it has in either of the last two years, primarily due to a large number of lease expirations. The store additions and closings discussed above include relocations, rebuilds and seasonal activity.

The customer-driven approach to merchandising focuses on providing the customer an expanded selection of quality products at a good value. This is being accomplished by emphasizing the importance of ordering at the store level, removing slow-moving items and aggressively introducing new, high-potential products in the early stages of their life cycle. This process represents an ongoing effort to satisfy the ever-changing preferences of our customers.

The Company's everyday-fair-pricing strategy is designed to provide consistent prices on all items by reducing its reliance on discounting. When the everyday-fair-pricing strategy was introduced, some product prices were lowered, while others were increased to achieve more consistency. Going forward, the Company plans to migrate toward lower retail prices as lower product costs are achieved through contract negotiations or strategic alliances with suppliers and distributors.

Daily delivery of time-sensitive or perishable items along with high-quality, ready-to-eat foods is another key management strategy. Implementation of this strategy includes third-party development and operation of combined distribution centers ("CDC"), fresh-food commissaries and bakery facilities in many of the Company's markets around the

country. The commissary and bakery ready-to-eat items, like fresh sandwiches and pastries, along with goods from multiple vendors such as dairy products, bread, produce and other perishable goods, are "combined" at a distribution center and delivered daily to each store. In addition to providing fresher products, improved in-stock conditions and quicker response time on new items, the combined distribution is also intended to provide lower product costs, in part from vendors' savings, through this approach. At the end of 1997, over 2,800 stores were serviced by daily distribution facilities. Expansion of these programs to another 800 stores is anticipated in 1998.

The development of a retail information system ("RIS") began in 1994. The initial phase, completed in early 1996, involved installing in-store processors ("ISP") in each store to automate accounting and other store-level tasks. The current phase involves the installation of point-of-sale registers with scanning capabilities, as well as tools on the ISP to assist with ordering and product assortment, and a hand-held unit for ordering product from the sales floor. After completion, the system will provide each store and its suppliers and distributors with on-line information to make better decisions in anticipating customer needs. Management believes that the effective utilization of daily sales data gathered by the system will improve sales through reducing out-of-stock incidents and enhancing each individual store's product mix to better match customers' needs. In addition, the system will assist with monitoring inventories to better control shortage and product write-offs. While implementation costs during the roll-out phase are expected to exceed the short-term benefits, the anticipated long-term benefits of this system, coupled with further cost reductions resulting from automation, are expected to help the Company reach its goal of sustained profitable growth over the long term. This phase of the system is currently expected to be fully operational for all stores by early 2000.

(Except where noted, all per-store numbers refer to an average of all stores rather than only stores open more than one year.)

Sales

The Company recorded net sales of $6.97 billion for the year ended December 31, 1997, compared to sales of $6.87 billion in 1996 and $6.75 billion in 1995. The increase in net sales in 1997 over 1996 was a result of same-store merchandise sales growth, combined with an increase in stores that sold gasoline. The net sales increase in 1996 when compared to 1995 was due to same-store merchandise sales growth, combined with an increase in the sales price of gasoline. The following table illustrates the growth in merchandise sales:

Merchandise Sales Growth Data (per-store) **Years Ended December 31**	**1997**	**1996**	**1995**
Increase (decrease) from prior year			
U.S. same-store sales growth	1.5%	1.4%	2.0%
U.S. same-store real sales growth, excluding inflation	.6%	(1.0)%	—
7-Eleven inflation	.9%	2.4%	2.1%

The last two quarters of 1997 reflected a favorable merchandise sales trend, with third-quarter U.S. same-store merchandise sales growth of 2.2%, followed by fourth-quarter growth of 2.8%, the highest such increase since the fourth quarter of 1994. The Company believes that this trend is, in part, a result of changes made to the merchandising organization and its processes in the second quarter of 1997.

While average per-store merchandise sales growth in 1997 and 1996 was fairly consistent among the various geographical areas, category results were mixed:

- Categories driving the 1997 merchandise sales increase were coffee, Slurpee, non-carbonated beverages, tobacco, services, fresh bakery and roller grill products. Certain mature categories like candy and soft drinks were virtually flat, while others such as fountain drinks and bread had slight declines.
- Categories with significant sales improvement in 1996 included pre-paid cards and services, while traditional convenience store products such as cigarettes, non-alcoholic beverages and candy, which account for almost 40% of merchandise sales, had below-average growth.

During 1995 average per-store merchandise sales results varied by geographic region. The largest sales increases occurred in those areas with the highest percentage of completed remodels (Florida 4.8%, Texas/Colorado 4.1%). Conversely, the Southern California area, which included 18% of the Company's domestic stores, experienced a decline of almost 1.5% due to a sluggish economy.

Gasoline sales dollars per store decreased slightly in 1997 after increases of 7.3% and 4.0% in 1996 and 1995, respectively. Contributing to the 1997 decrease was a .7% decline in average per-store gallon volume with the sales price being virtually flat to 1996. In 1996, the increase was mostly due to the average sales price per gallon increasing almost 9 cents per gallon over 1995.

Other Income

Other income of $89.4 million for 1997 was $3.1 million higher than 1996 and $11.0 million higher than 1995. The improvement is primarily the result of increased royalty income from licensed operations. While some of the royalty income could be unfavorably impacted by fluctuating exchange rates, approximately 70% of the royalties are from area license agreements with SEJ. Though the dollar equivalent of the SEJ royalty income will fluctuate with exchange rate movements, the Company has effectively hedged this exposure by using the royalty income to make principal and interest payments on its yen-denominated loan.

Upon repayment of the yen loan, currently projected for 2001, the royalty income will not be pledged. Thereafter, the royalties under that license agreement will again be paid to the Company or may be used to collateralize other financing arrangements. One year following such repayment, the yen-denominated royalty payments from SEJ will be reduced by approximately two-thirds in accordance with terms of the license agreement.

Gross Profits

Merchandise Gross Profit Data

Years Ended December 31	**1997**	**1996**	**1995**
Merchandise Gross Profit — dollars in millions	$ 1,828.4	$ 1,787.7	$ 1,790.2
Increase (decrease) from prior year — all stores			
Average per-store gross profit dollar change	2.3%	2.1%	3.1%
Margin percentage point change	.12	(.19)	(.01)
Average per-store merchandise sales	1.9%	2.7%	3.1%

Total merchandise gross profit dollars increased in 1997 from both higher average per-store sales and margins. The decline in 1996 was primarily from store closings and a slightly lower margin.

The increase in merchandise margin in 1997 was primarily due to improved sales in some higher-margin categories like Slurpee, coffee, non-carbonated beverages and services. These increases were partially offset by higher write-offs, as the Company focused on expanding its fresh-food program, both geographically and with new products. More aggressive retail pricing continues to present a challenge in today's increasingly more competitive environment. Management is actively working to improve merchandise margin while providing fair and consistent prices.

Cigarettes currently contribute approximately 14% of both the Company's total merchandise gross profit and total sales. With the recent legal settlements between cigarette manufacturers and several state governments, the Company anticipates that the cost of cigarettes could rise in the near future. Additionally, there are numerous examples of pending state and federal legislation aimed at reducing minors' consumption of tobacco products which include significant increases in cigarette taxes. It is impossible to predict the exact impact these potential cost increases would have on the Company's gross profits, partially due to uncertainties regarding competitor reaction to the increases.

During 1996, merchandise margin declined slightly due to three main factors: rising product costs, lower-than-average sales growth of high-margin items and higher product write-offs.

In 1995, sales of higher-margin categories like pre-paid phone cards and services performed well enough to offset cost increases in various other categories that could not be passed on to the consumer for competitive reasons.

Gasoline Gross Profit Data

Years Ended December 31	**1997**	**1996**	**1995**
Gasoline Gross Profit — dollars in millions	$ 183.8	$ 188.1	$ 192.9
Increase (decrease) from prior year			
Average per-store gross profit dollar change	(3.5)%	(1.4)%	(3.3)%
Margin point change (in cents per gallon)	(.38)	(.17)	(.60)
Average per-store gas gallonage	(.7)%	(.1)%	1.0%

In 1997, gasoline gross profits declined $4.4 million from the levels achieved in 1996. Excluding the stores on the West Coast, the Company's gasoline gross profits increased $1.2 million in 1997 compared to 1996. This increase was comprised of a slight average per-store gallon increase and an increase in gas store months. The stores on the West Coast (24% of the Company's total gas stores) were impacted by industry product supply problems and intense competitive conditions, creating a situation where, in some cases, the Company's cost exceeded other operators' retail price of gasoline. In general, over the last two years, lower margins (in cents per gallon) have been created by market conditions that have kept wholesale costs high, while competitive pressures have kept retail prices in check. In many of these situations, the Company has chosen to maintain margin levels at the expense of gallonage growth. Although competitive pressures will continue, the Company feels there is a chance the industry supply problems experienced over the last two years may be easing.

Operating, Selling, General and Administrative Expenses ("OSG&A")

(Dollars in Millions)

Years Ended December 31	1997	1996	1995
Total operating, selling, general and administrative expenses	$ 1,896.2	$ 1,841.2	$ 1,874.5
Ratio of OSG&A to sales	27.2%	26.8%	27.8%
Increase (decrease) in OSG&A compared to prior year	$ 55.0	$ (33.3)	$ (22.3)

The increase in OSG&A expenses, and the ratio to sales, in 1997 compared to 1996, is primarily the result of the following factors: incremental costs related to the retail information system initiatives; increase in store labor due to a tight labor market and minimum wage increases; higher depreciation expense due to the extensive remodeling program completed in late 1996; completion of new stores and other initiatives; more environmental remediation; and higher store insurance due to the comparison with favorable claims experience reflected in 1996.

OSG&A expenses, and the ratio to sales, declined in 1996, when compared to 1995, despite the incremental costs of the retail information system initiatives. The largest item contributing to the improvement was lower insurance costs. Based upon favorable claims experience, the Company lowered its insurance accruals. Other factors aiding the comparison included the absence of a significant restructuring charge compared to a charge of $13.4 million in 1995, declines in environmental remediation expenses, savings from reductions in force and lower expenses from having fewer stores.

The majority of the decrease in OSG&A expenses in 1995 resulted from cost savings realized from reductions in force, combined with the effect of having fewer stores (see Management Strategies). In December 1995, the Company accrued $13.4 million for severance costs and realignment of office space. These reductions were substantially complete in 1996, and changes in estimates from the original accrual did not have a material impact on 1996 earnings.

The Company continues to review the functions necessary to enable its stores to respond faster and more cost efficiently to rapidly changing customer needs and preferences. In conjunction with this review, management continues to realign and reduce personnel and office facilities, in order to eliminate non-essential costs, while devoting resources to the implementation of its retail information system and other strategic initiatives. In early 1998, the Company implemented additional changes and anticipates reflecting a one-time charge for severance benefits of approximately $6.0 million in the first quarter of 1998. Management expects future periods' expenses to increase with the continued roll-out of the retail information system and, accordingly, the ratio to sales is anticipated to increase until the roll-out is substantially complete and more related benefits are attained (see Management Strategies).

The Company is a defendant in two legal actions, which are referred to as the 7-Eleven OFFF and Valente cases, filed by franchisees in 1993 and 1996, respectively, asserting various claims against the Company. A nationwide settlement has recently been negotiated and, in connection with the settlement, these two cases have been combined on behalf of a class of all persons who operated 7-Eleven convenience stores in the United States at any time between January 1, 1987 and July 31, 1997, under franchise agreements with the Company. Class members have until March 31, 1998 to opt out of the settlement, and a final hearing to approve the settlement is currently scheduled on April 24, 1998. The Company's accruals are sufficient to cover the payment due under the settlement with no material impact upon 1997 earnings, as well as no anticipated impact on 1998 earnings.

Interest Expense, Net

Net interest expense decreased slightly in 1997 compared to 1996 due to lower average borrowing throughout the year, partially offset by lower interest income due to the 1996 money order agreement.

Approximately 37% of the Company's debt contains floating rates that would be unfavorably impacted by rising interest rates. The weighted average interest rate for such debt was 5.80% for 1997 versus 5.83% and 6.62% for 1996 and 1995, respectively. The Company expects net interest expense in 1998 to remain relatively flat, based upon anticipated levels of debt and interest rate projections, but there will be several offsetting items impacting interest expense. Factors increasing 1998 interest expense include higher borrowings/obligations to finance new store development and the redemption of the Company's 12% Senior Subordinated Debentures ("12% Debentures") which currently recognize no interest expense in accordance with SFAS No. 15 "Accounting by Debtors and Creditors for Troubled Debt Restructuring," as discussed further in the Debentures section of Note 8 to the Consolidated Financial Statements. This redemption is being funded with 4½% Convertible Quarterly Income Debt Securities ("1998 Convertible Debt") due 2013 (see Liquidity and Capital Resources). Items which will decrease 1998 interest expense include a lower interest rate on the existing yen-denominated loan and higher capitalized interest. The interest rate on the existing yen-denominated loan will be reset in March of 1998, resulting in an estimated rate reduction of approximately 315 basis points.

Net interest expense increased $4.6 million in 1996 compared to 1995 due to lower interest income, combined with higher interest expense from the Convertible Quarterly Income Debt Securities ("1995 Convertible Debt") due 2010 which were issued in November 1995 and are not accounted for under SFAS No. 15. The lower interest income was primarily the result of a new money order agreement that eliminated interest income from the funding arrangement; however, it provided lower cost of goods and operating costs, which more than offset the impact of the lost interest. Interest on the 1995 Convertible Debt was almost entirely offset by reduced principal balances and lower rates on floating rate debt.

In accordance with SFAS No. 15, no interest expense is recognized on the Company's public debt securities. These securities were recorded at an amount equal to the future undiscounted cash payments, both principal and interest, and, accordingly, the cash interest payments are charged against the recorded amount of such securities and are not treated as interest expense.

Income Taxes

The Company recorded tax expense in 1997 of $45.3 million, $41.3 million in 1996 and a tax benefit of $66.1 million in 1995. Higher income tax expense in 1997, when compared to 1996, was due to the settlement of an IRS tax examination, resulting in a $7.3 million tax benefit in 1996. The increase in 1996 taxes versus 1995 resulted from the rise in earnings before income taxes and extraordinary items, which increased by 29% in 1996 compared to 1995. The tax benefit in 1995 was the result of reversing a valuation allowance, based on the Company's demonstrated ability to produce higher levels of taxable income, resulting in the recognition of an $84.3 million deferred tax asset.

Extraordinary Gain

On November 22, 1995, the Company completed a tender offer for 40% of the face value of both its 5% First Priority Senior Subordinated Debentures due December 15, 2003 ($180.6 million) and 4½% Second Priority Senior Subordinated Debentures-Series A ($82.7 million) due June 15, 2004 (collectively, the "Debentures"). Under the terms of the offer the final clearing prices were $840.00 and $786.00 for the 5% and 4½% Debentures, respectively, per $1,000 face amount, resulting in a cash outlay by the Company of $216.7 million. To finance the purchase of the Debentures, the Company issued $300 million in 1995 Convertible Debt to Ito-Yokado Co., Ltd., and Seven-Eleven Japan Co., Ltd., the joint owners of IYG Holding Company, which is the Company's majority shareholder. The Company recognized a $103.2 million after-tax extraordinary gain on the purchase of the Debentures in the fourth quarter of 1995. The gain resulted from purchasing the Debentures below their face value and from retiring the future undiscounted interest payments on that portion of the Debentures that were purchased (see Interest Expense, Net section).

Liquidity and Capital Resources

The majority of the Company's working capital is provided from three sources: i) cash flows generated from its operating activities; ii) a $400 million commercial paper facility (guaranteed by Ito-Yokado Co., Ltd.); and iii) short-term seasonal borrowings of up to $400 million (reduced by outstanding letters of credit) under its revolving credit facility. The Company believes that operating activities, coupled with available short-term working capital facilities, will provide sufficient liquidity to fund current operating and capital expenditure programs, as well as to service debt requirements.

In February 1998, the Company issued $80 million of 1998 Convertible Debt to Ito-Yokado Co., Ltd., and Seven-Eleven Japan Co., Ltd. The 1998 Convertible Debt is subordinated to all existing debt except the 1995 Convertible Debt which has the same priority ranking. The debt has a 15-year life, no amortization and an interest rate of 4.5%. The instrument gives the Company the right to defer interest payments thereon for up to 20 consecutive quarters. The debt mandatorily converts into 32,508,432 shares of the Company's common stock if the Company's stock achieves certain levels after the third anniversary of issuance. The proceeds from the 1998 Convertible Debt will be used to redeem the Company's 12% Debentures at par with the remainder to be used for general corporate purposes. Redemption of the 12% Debentures will result in a gain of nearly $30 million from the retirement of future undiscounted interest payments as recorded under SFAS No. 15.

In February 1997, the Company entered into a new unsecured bank debt credit agreement ("New Credit Agreement"), refinancing its old term loan ($225 million), revolving credit facility and letters of credit ($150 million each), collectively secured under the senior bank debt credit agreement ("Old Credit Agreement"), all of which were scheduled to mature on December 31, 1999, with a new term loan facility ("Term Loan") and revolving credit facility. The Term Loan ($225 million) has scheduled quarterly repayments of $14.1 million commencing March 31, 1998 through December 31, 2001. The new revolving credit facility ($400 million) expires February 2002 and allows for revolving borrowings ("Revolver"), and for issuance of letters of credit not to exceed $150 million. Interest on the Term Loan and Revolver is based on a variable rate equal to the administrative agent bank's base rate or, at the Company's option, a rate equal to a reserve-adjusted Eurodollar rate plus .225% per year for drawn amounts. The new agreement requires letter of credit fees to be paid quarterly at .325% per year on the outstanding amount. In addition, a facility fee of .15% per year is charged on the aggregate amount of the New Credit Agreement facility and is payable quarterly. The cost of borrowings and letters of credit under the New Credit Agreement represents a decrease of .6% and .45% per year, respectively, from the Old Credit Agreement.

In April 1997, the Company entered into a $115 million Master Lease Facility ("MLF"), which will be the primary financing for a complete integrated point-of-sale system (see Management Strategies). The lease payment on the MLF will be based on a variable rate equal to the LIBOR rate plus a blended all-inclusive spread of .46% per year. The six-and-one-half-year MLF has a three-year noncancelable term with semiannual renewal options. The commitment period for this lease expires in early 1999, and, based upon current roll-out schedules, the Company does not expect the MLF to be fully funded at that time. As a result, the Company intends to seek an extension of the MLF or find other financing, by the end of 1998, to fully fund the roll-out of the point-of-sale system.

The New Credit Agreement contains certain financial and operating covenants requiring, among other things, the maintenance of certain financial ratios, including interest and rent coverage, fixed-charge coverage and senior indebtedness to earnings before interest, taxes, depreciation and amortization ("EBITDA"). The covenant levels established by the New Credit Agreement generally require continuing improvement in the Company's financial condition. The covenants in the New Credit Agreement, when compared to the Old Credit Agreement, allow the Company more flexibility in its borrowing levels and capital expenditures.

For the period ended December 31, 1997, the Company was in compliance with all of the covenants required under the New Credit Agreement, including compliance with the principal financial and operating covenants (calculated over the latest 12-month period) as follows:

Covenants	Actuals	Requirements Minimum	Requirements Maximum
Interest coverage*	2.13 to 1.0	2.00 to 1.0	—
Fixed charge coverage	1.04 to 1.0	0.65 to 1.0	—
Senior indebtedness to EBITDA	3.20 to 1.0	—	3.40 to 1.0

**includes effects of the SFAS No. 15 interest payments.*

In 1997, the Company repaid $74.0 million of debt, which included $33.2 million for principal payments on the Company's yen-denominated loan (hedged by the royalty income stream from its area licensee in Japan) and $22.4 million for SFAS No. 15 interest. Outstanding balances at December 31, 1997, for the commercial paper, the Term Loan and the Revolver, were $398.7 million, $225.0 million and $62.0 million, respectively. As of December 31, 1997, outstanding letters of credit issued pursuant to the New Credit Agreement totaled $63.8 million.

Cash from Operating Activities

Net cash provided by operating activities was $197.9 million for 1997, compared to $261.0 million in 1996 and $236.2 million in 1995. Contributing to the decrease in net cash from operating activities was an increase in inventories, caused by a December 1997 cigarette buy-in and generally higher per-store inventory levels, combined with the timing of payments and receipts (see Results of Operations section).

Capital Expenditures

During 1997, net cash used in investing activities consisted primarily of payments of $232.5 million for property and equipment. The majority of this capital was used for new store development, continued implementation of the Company's retail information system, remodeling stores, new equipment to support merchandising initiatives, upgrading retail gasoline facilities, replacing equipment and complying with environmental regulations.

The proceeds from the sale of property and equipment primarily consists of the sale/leaseback funding of the master lease facility (see Note 12 of Notes to Consolidated Financial Statements).

The Company expects 1998 capital expenditures, excluding lease commitments, to exceed $300 million. Capital expenditures are being used to develop or acquire new stores, upgrade store facilities, further implement a retail information system, replace equipment, upgrade gasoline facilities and comply with environmental regulations. The amount of expenditures during the year will be materially impacted by the proportion of new store development funded through working capital versus leases and the speed at which new sites/acquisitions can be located, negotiated, permitted and constructed.

In February 1998, the Company announced the signing of a definitive agreement with MDK Corporation of Goshen, Ind., to acquire 23 'red D mart' convenience stores in the South Bend, Indiana, area. The transaction is scheduled to be complete in mid-1998.

Capital Expenditures — Gasoline Equipment

The Company incurs ongoing costs to comply with federal, state and local environmental laws and regulations primarily relating to underground storage tank ("UST") systems. The Company anticipates it will spend approximately $10 million in 1998 on capital improvements required to comply with environmental regulations relating to USTs, as well as above-ground vapor recovery equipment at store locations, and approximately an additional $25 million on such capital improvements from 1999 through 2001.

Environmental

In December 1988, the Company closed its chemical manufacturing facility in New Jersey. As a result, the Company is required to conduct environmental remediation at the facility and has submitted a clean-up plan to the New Jersey Department of Environmental Protection (the "State"), which provides for active remediation of the site for approximately a three-to-five-year period, as well as continued groundwater monitoring and treatment for a projected 15-year planning period. The projected 15-year clean-up period represents a reduction from the previously reported 20-year period and is a result of revised estimates as determined by an independent environmental management company in the first quarter of 1997. These revised estimates, which generally resulted from the conditional approval of the Company's plan, reduced both the estimated time and the estimated costs to complete the project and resulted in decreasing the liability and the related receivable balances by \$16.3 million and \$9.7 million, respectively. While conditional approval was received on its clean-up plan, the Company must supply additional information to the State before the plan can be finalized. The Company has recorded undiscounted liabilities representing its best estimates of the clean-up costs of \$10.4 million at December 31, 1997. In 1991, the Company and the former owner of the facility executed a final settlement pursuant to which the former owner agreed to pay a substantial portion of the clean-up costs. Based on the terms of the settlement agreement and the financial resources of the former owner, the Company has recorded a receivable of \$6.1 million at December 31, 1997.

Additionally, the Company accrues for the anticipated future costs and the related probable state reimbursement amounts for remediation activities at its existing and previously operated gasoline sites where releases of regulated substances have been detected. At December 31, 1997, the Company's estimated undiscounted liability for these sites was \$40.9 million. This estimate is based on the Company's prior experience with gasoline sites and its consideration of such factors as the age of the tanks, location of tank sites and experience with contractors who perform environmental assessment and remediation work. The Company anticipates that substantially all of the future remediation costs for detected releases at these sites as of December 31, 1997, will be incurred within the next five years.

Under state reimbursement programs, the Company is eligible to receive reimbursement for a portion of future remediation costs, as well as a portion of remediation costs previously paid. Accordingly, at December 31, 1997, the Company has recorded a net receivable of \$44.8 million for the estimated probable state reimbursements. In assessing the probability of state reimbursements, the Company takes into consideration each state's fund balance, revenue sources, existing claim backlog, status of clean-up activity and claim ranking systems. As a result of these assessments, the recorded receivable amount is net of an allowance of \$9.7 million. While there is no assurance of the timing of the receipt of state reimbursement funds, based on its experience, the Company expects to receive the majority of state reimbursement funds, except from California, within one to three years after payment of eligible remediation expenses, assuming that the state administrative procedures for processing such reimbursements have been fully developed. The Company estimates that it may take one to seven years to receive reimbursement funds from California. Therefore, the portion of the recorded receivable amounts that relate to sites where remediation activities have been conducted has been discounted at 5.7% to reflect their present value. Thus, the recorded receivable amount is also net of a discount of \$6.0 million.

The estimated future assessment and remediation expenditures and related state reimbursement amounts could change within the near future as governmental requirements and state reimbursement programs continue to be implemented or revised.

Year 2000

The year 2000 issue is the result of computer programs being written using two digits rather than four to define the applicable year. Some of the Company's older computer programs that have date-sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in a system failure or miscalculations, causing disruption of operations.

The Company has replaced, over the last couple of years, or has plans to replace significant portions of its existing systems with third-party-provided software which properly interpret dates beyond December 31, 1999. In addition, the Company has contracted resources to modify the remainder of its existing software to make it year 2000 compliant. Based on a recent assessment, the Company believes all system modifications and related testing should be completed by early 1999.

The Company has initiated formal communications with its significant suppliers to determine the extent to which the Company is vulnerable to those third parties' failure to remediate their own year 2000 issue. At this time, based on presently available information, the Company does not foresee any material effects related to outside-company compliance.

The Company does not believe the costs related to the year 2000 compliance project will be material to its financial position or results of operations. However, the costs of the project and the date on which the Company plans to complete the year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events including the continued availability of certain resources, third-party modification plans and other factors. As a result, there can be no assurance that these estimates will be achieved and the actual costs and vendor compliance could differ materially from those plans, resulting in a material financial risk.

(Dollars in Thousands, Except Per-Share Data)

December 31	1997	1996
Assets		
Current assets:		
Cash and cash equivalents	$ 38,605	$ 36,494
Accounts receivable	126,495	109,413
Inventories	125,396	109,050
Other current assets	96,145	95,943
Total current assets	386,641	350,900
Property and equipment	1,416,687	1,349,839
Other assets	286,753	338,409
	$ 2,090,081	$ 2,039,148
Liabilities and Shareholders' Equity (Deficit)		
Current liabilities:		
Trade accounts payable	$ 196,799	$ 211,060
Accrued expenses and other liabilities	275,267	297,246
Commercial paper	48,744	98,055
Long-term debt due within one year	208,839	68,571
Total current liabilities	729,649	674,932
Deferred credits and other liabilities	187,414	214,343
Long-term debt	1,594,545	1,638,828
Convertible quarterly income debt securities	300,000	300,000
Commitments and contingencies		
Shareholders' equity (deficit):		
Common stock, $.0001 par value; 1,000,000,000 shares authorized; 409,922,935 shares issued and outstanding	41	41
Additional capital	625,574	625,574
Accumulated deficit	(1,347,142)	(1,414,570)
Total shareholders' equity (deficit)	(721,527)	(788,955)
	$ 2,090,081	$ 2,039,148

See notes to consolidated financial statements.

(Dollars in Thousands, Except Per-Share Data)

Years Ended December 31	1997	1996	1995
Revenues:			
Net sales (including $971,124, $961,987 and $977,828 in excise taxes)	$ 6,971,145	$ 6,868,912	$ 6,745,820
Other income	89,412	86,351	78,458
	7,060,557	6,955,263	6,824,278
Costs and expenses:			
Cost of goods sold	4,958,926	4,893,061	4,762,707
Operating, selling, general and administrative expenses	1,896,206	1,841,174	1,874,460
Interest expense, net	90,130	90,204	85,582
	6,945,262	6,824,439	6,722,749
Earnings before income taxes and extraordinary gain	115,295	130,824	101,529
Income taxes (benefit)	45,253	41,348	(66,065)
Earnings before extraordinary gain	70,042	89,476	167,594
Extraordinary gain on debt redemption (net of tax effect of $8,603)	—	—	103,169
Net earnings	$ 70,042	$ 89,476	$ 270,763
Earnings before extraordinary gain per common share:			
Basic	$ .17	$ .22	$ .41
Diluted	.16	.20	.40
Extraordinary gain on debt redemption per common share:			
Basic	$ —	$ —	$ .25
Diluted	—	—	.25
Net earnings per common share:			
Basic	$ .17	$ .22	$ .66
Diluted	.16	.20	.65

See notes to consolidated financial statements.

(Dollars in Thousands, Except Share Amounts)	Common Stock Shares	Common Stock Amount	Additional Capital	Accumulated Deficit	Total Shareholders' Equity (Deficit)
Balance, January 1, 1995	409,922,935	$ 41	$ 625,574	$ (1,782,846)	$ (1,157,231)
Net earnings	—	—	—	270,763	270,763
Foreign currency translation adjustments	—	—	—	(2,470)	(2,470)
Unrealized gains on equity securities, net of tax	—	—	—	8,146	8,146
Balance, December 31, 1995	409,922,935	41	625,574	(1,506,407)	(880,792)
Net earnings	—	—	—	89,476	89,476
Foreign currency translation adjustments	—	—	—	(258)	(258)
Unrealized gains on equity securities, net of tax	—	—	—	2,619	2,619
Balance, December 31, 1996	409,922,935	41	625,574	(1,414,570)	(788,955)
Net earnings	—	—	—	70,042	70,042
Foreign currency translation adjustments	—	—	—	(1,040)	(1,040)
Unrealized gains on equity securities, net of tax	—	—	—	(1,574)	(1,574)
Balance, December 31, 1997	409,922,935	$ 41	$ 625,574	$ (1,347,142)	$ (721,527)

See notes to consolidated financial statements.

(Dollars in Thousands)

Years Ended December 31	1997	1996	1995
Cash flows from operating activities:			
Net earnings	$ 70,042	$ 89,476	$ 270,763
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Extraordinary gain on debt redemption	—	—	(103,169)
Depreciation and amortization of property and equipment	177,174	166,347	147,423
Other amortization	19,026	19,026	19,026
Deferred income taxes (benefit)	31,812	23,790	(84,269)
Noncash interest expense	2,342	1,746	1,974
Other noncash expense (income)	96	182	(409)
Net loss on property and equipment	2,391	1,714	7,274
(Increase) decrease in accounts receivable	(6,560)	4,824	(2,708)
Increase in inventories	(16,346)	(7,030)	(552)
(Increase) decrease in other assets	(5,781)	386	(1,053)
Decrease in trade accounts payable and other liabilities	(76,250)	(39,421)	(18,083)
Net cash provided by operating activities	197,946	261,040	236,217
Cash flows from investing activities:			
Payments for purchase of property and equipment	(232,539)	(194,373)	(192,221)
Proceeds from sale of property and equipment	39,648	14,499	15,720
Other	6,908	9,588	2,770
Net cash used in investing activities	(185,983)	(170,286)	(173,731)
Cash flows from financing activities:			
Proceeds from commercial paper and revolving credit facilities	5,907,243	4,292,215	4,171,927
Payments under commercial paper and revolving credit facilities	(5,842,539)	(4,249,134)	(4,256,918)
Proceeds from issuance of long-term debt	225,000	—	—
Principal payments under long-term debt agreements	(299,005)	(140,388)	(289,372)
Proceeds from issuance of convertible quarterly income debt securities	—	—	300,000
Debt issuance costs	(551)	—	(4,364)
Net cash used in financing activities	(9,852)	(97,307)	(78,727)
Net increase (decrease) in cash and cash equivalents	2,111	(6,553)	(16,241)
Cash and cash equivalents at beginning of year	36,494	43,047	59,288
Cash and cash equivalents at end of year	$ 38,605	$ 36,494	$ 43,047
Related disclosures for cash flow reporting:			
Interest paid, excluding SFAS No. 15 Interest	$ (97,568)	$ (100,777)	$ (97,945)
Net income taxes paid	$ (10,482)	$ (18,918)	$ (34,674)
Assets obtained by entering into capital leases	$ 56,745	$ 3,761	$ 71

See notes to consolidated financial statements.

Years Ended December 31, 1997, 1996 and 1995

1. Accounting Policies

Principles of Consolidation

The Southland Corporation and subsidiaries (the "Company") is owned approximately 65% by IYG Holding Company, which is jointly owned by Ito-Yokado Co., Ltd. ("IY") and Seven-Eleven Japan Co., Ltd. ("SEJ").

The consolidated financial statements include the accounts of The Southland Corporation and its subsidiaries. Intercompany transactions and account balances are eliminated. Prior-year and quarterly amounts have been reclassified to conform to the current-year presentation.

The Company operates more than 5,400 7-Eleven and other convenience stores in the United States and Canada. Area licensees, or their franchisees, and affiliates operate approximately 11,700 additional 7-Eleven convenience stores in certain areas of the United States, in 18 foreign countries and in the U.S. territories of Guam and Puerto Rico. The Company's net sales are comprised of sales of groceries, take-out foods and beverages, gasoline (at certain locations), dairy products, non-food merchandise, specialty items and services.

Net sales and cost of goods sold of stores operated by franchisees are consolidated with the results of Company-operated stores. Net sales of stores operated by franchisees are $2,880,148,000, $2,860,768,000 and $2,832,131,000 from 2,868, 2,927 and 2,896 stores for the years ended December 31, 1997, 1996 and 1995, respectively.

Under the present franchise agreements, initial franchise fees are recognized in income currently and are generally calculated based upon gross profit experience for the store or market area. These fees cover certain costs including training, an allowance for travel, meals and lodging for the trainees and other costs relating to the franchising of the store.

The gross profit of the franchise stores is split between the Company and its franchisees. The Company's share of the gross profit of franchise stores is its continuing franchise fee, generally ranging from 50% to 58% of the gross profit of the store, which is charged to the franchisee for the license to use the 7-Eleven operating system and trademarks, for the lease and use of the store premises and equipment, and for continuing services provided by the Company. These services include merchandising, advertising, recordkeeping, store audits, contractual indemnification, business counseling services and preparation of financial summaries. The gross profit earned by the Company's franchisees of $524,941,000, $520,216,000 and $518,777,000 for the years ended December 31, 1997, 1996 and 1995, respectively, is included in the Consolidated Statements of Earnings as operating, selling, general and administrative expenses ("OSG&A").

Sales by stores operated under domestic and foreign area license agreements are not included in consolidated revenues. All fees or royalties arising from such agreements are included in other income. Initial fees, which have been immaterial, are recognized when the services required under the agreements are performed.

Other Income

Other income is primarily area license royalties and franchise fee income. The area license royalties include amounts from area license agreements with SEJ of approximately $50,000,000, $47,000,000 and $44,000,000 for the years ended December 31, 1997, 1996 and 1995, respectively.

Comprehensive Income

The Company intends to adopt Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income," in 1998. The statement establishes standards for reporting comprehensive income and its components in a full set of general-purpose financial statements. Comprehensive income is the change in equity of a business enterprise during a period from net income and other events, except activity resulting from investments by owners and distributions to owners. SFAS No. 130 becomes effective for fiscal years beginning after December 15, 1997.

Operating, Selling, General and Administrative Expenses

Buying and occupancy expenses are included in OSG&A. Advertising costs, also included in OSG&A, generally are charged to expense as incurred and were $35,111,000, $34,707,000 and $39,569,000 for the years ended December 31, 1997, 1996 and 1995, respectively.

Interest Expense

Interest expense is net of interest income of $8,788,000, $10,649,000 and $16,975,000 for the years ended December 31, 1997, 1996 and 1995, respectively.

Income Taxes

Income taxes are determined using the liability method, where deferred tax assets and liabilities are recognized for temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets include tax carryforwards and are reduced by a valuation allowance if, based on available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Cash and Cash Equivalents

The Company considers all highly liquid investment instruments purchased with maturities of three months or less to be cash equivalents. Cash and cash equivalents include temporary cash investments of $5,240,000 and $12,252,000 at December 31, 1997 and 1996, respectively, stated at cost, which approximates market.

Inventories

Inventories are stated at the lower of cost or market. Cost is generally determined by the LIFO method for stores in the United States and by the FIFO method for stores in Canada.

Depreciation and Amortization

Depreciation of buildings and equipment is based on the estimated useful lives of these assets using the straight-line method. Acquisition and development costs for significant business systems and related software for internal use are capitalized and are depreciated on a straight-line basis over a three-to-seven-year period based on their estimated useful lives. Amortization of capital leases, improvements to leased properties and favorable leaseholds is based on the remaining terms of the leases or the estimated useful lives, whichever is shorter.

Foreign and domestic area license royalty intangibles were recorded in 1987 at the fair value of future royalty payments and are being amortized over 20 years using the straight-line method. The 20-year life is less than the estimated lives of the various royalty agreements, the majority of which are perpetual.

Store Closings/Asset Impairment

Provision is made on a current basis for the write-down of identified owned-store closings to their net realizable value. For identified leased-store closings, leasehold improvements are written down to their net realizable value and a provision is made on a current basis if anticipated expenses are in excess of expected sublease rental income. The Company's long-lived assets are reviewed for impairment and written down to fair value whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

Stock-Based Compensation

The Company has adopted the disclosure-only requirements of SFAS No. 123, "Accounting for Stock-Based Compensation," and therefore continues to apply the provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," in accounting for its stock-based compensation plans. Pursuant to the requirements of SFAS No. 123, which defines a fair-value-based method of accounting for employee stock options, the Company provides pro forma net earnings and earnings-per-share disclosures as if it were using that statement to account for its employee stock option plans.

Environmental

Environmental expenditures related to existing conditions resulting from past or current operations and from which no current or future benefit is discernible are expensed by the Company. Expenditures that extend the life of the related property or prevent future environmental contamination are capitalized. The Company determines its liability on a site-by-site basis and records a liability when it is probable and can be reasonably estimated. The estimated liability of the Company is not discounted.

A portion of the environmental expenditures incurred for gasoline sites is eligible for refund under state reimbursement programs. A related receivable is recorded for estimated probable refunds. The receivable is discounted if the amount relates to sites where remediation activities have been conducted. A receivable is also recorded to reflect estimated probable reimbursement from other parties.

Insurance

The Company has established insurance programs to cover certain insurable risks consisting primarily of physical loss to property, business interruptions resulting from such loss, workers' compensation, employee healthcare, comprehensive general and auto liability. Third-party insurance coverage is obtained for property and casualty exposures above predetermined deductibles as well as those risks required to be insured by law or contract. Provisions for losses expected under the insurance programs are recorded based on independent actuarial estimates of the aggregate liabilities for claims incurred.

Business Segment

The Company operates in a single business segment — the operating, franchising and licensing of convenience food stores, primarily under the 7-Eleven name. SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," was recently issued and the Company is reviewing its requirements to determine the effect on future disclosures. SFAS No. 131 becomes effective for fiscal years beginning after December 15, 1997.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Accounts Receivable

(Dollars in Thousands)

December 31	1997	1996
Trade accounts receivable	$ 50,235	$ 37,690
Franchisee accounts receivable	55,449	46,345
Environmental cost reimbursements (net of long-term portion of $38,716 and $53,886) — see Note 13	12,219	14,366
Other accounts receivable	15,388	16,021
	133,291	114,422
Allowance for doubtful accounts	(6,796)	(5,009)
	$ 126,495	$ 109,413

3. Inventories

Inventories stated on the LIFO basis that are included in inventories in the accompanying Consolidated Balance Sheets were $81,360,000 and $66,272,000 at December 31, 1997 and 1996, respectively, which is less than replacement cost by $31,525,000 and $31,418,000, respectively.

4. Other Current Assets

(Dollars in Thousands)

December 31	1997	1996
Prepaid expenses	$ 22,640	$ 20,298
Deferred tax assets — see Note 14	65,640	70,438
Other	7,865	5,207
	$ 96,145	$ 95,943

5. Property and Equipment

(Dollars in Thousands)

December 31	1997	1996
Cost:		
Land	$ 461,568	$ 453,233
Buildings and leaseholds	1,356,856	1,310,927
Equipment	911,598	790,718
Construction in process	38,152	32,614
	2,768,174	2,587,492
Accumulated depreciation and amortization	(1,351,487)	(1,237,653)
	$ 1,416,687	$ 1,349,839

6. Other Assets

(Dollars in Thousands)

December 31	1997	1996
Japanese license royalty intangible (net of accumulated amortization of $165,019 and $149,004)	$ 153,482	$ 169,497
Other license royalty intangibles (net of accumulated amortization of $29,423 and $26,586)	27,181	30,018
Environmental cost reimbursements — see Note 13	38,716	53,886
Deferred tax assets — see Note 14	—	13,158
Other (net of accumulated amortization of $5,827 and $6,694)	67,374	71,850
	$ 286,753	$ 338,409

7. Accrued Expenses and Other Liabilities

(Dollars in Thousands)

December 31	1997	1996
Insurance	$ 69,412	$ 78,681
Compensation	42,931	45,256
Taxes	52,400	52,802
Environmental costs — see Note 13	19,818	23,654
Profit sharing — see Note 11	14,780	15,641
Interest	17,173	18,517
Other	58,753	62,695
	$ 275,267	$ 297,246

8. Debt

(Dollars in Thousands)

December 31	1997	1996
Bank Debt Term Loans	$ 225,000	$ 225,000
Bank Debt revolving credit facility	62,000	—
Commercial paper	350,000	300,000
5% First Priority Senior Subordinated Debentures due 2003	350,556	364,056
4¼% Second Priority Senior Subordinated Debentures (Series A) due 2004	159,823	165,387
4% Second Priority Senior Subordinated Debentures (Series B) due 2004	23,645	24,396
12% Second Priority Senior Subordinated Debentures (Series C) due 2009	51,853	54,468
6¼% Yen Loan	168,198	201,447
7½% Cityplace Term Loan due 2005	277,926	282,606
Capital lease obligations	125,777	82,833
Other	8,606	7,206
	1,803,384	1,707,399
Less long-term debt due within one year	208,839	68,571
	$ 1,594,545	$ 1,638,828

Bank Debt

At December 31, 1996, the Company was obligated to a group of lenders under a credit agreement that included term loans and a revolving credit facility. In February 1997, the Company repaid all amounts due under that credit agreement with proceeds from a group of lenders under a new, unsecured credit agreement ("Credit Agreement"). The new Credit Agreement includes a $225 million term loan, which replaced the previous term loan of equal amount, and a $400 million revolving credit facility. A sublimit of $150 million for letters of credit is included in the revolving credit facility. In addition, to the extent outstanding letters of credit are less than the $150 million maximum, the excess availability can be used for additional borrowings under the revolving credit facility.

The term loan, which matures on December 31, 2001, had no payments due in 1997. Commencing March 31, 1998, the loans will be repaid in 16 quarterly installments of $14,062,500. Upon expiration of the revolving credit facility in February 2002, all the then-outstanding letters of credit must expire and may need to be replaced, and all other amounts then outstanding will be due and payable in full. At December 31, 1997, outstanding letters of credit under the facility totaled $63,757,000.

Interest on the new term loan and borrowings under the revolving credit facility is generally payable quarterly and is based on a variable rate equal to the administrative agent bank's base rate or, at the Company's option, at a rate equal to a reserve-adjusted Eurodollar rate plus .225% per year. A fee of .325% per year on the

outstanding amount of letters of credit is required to be paid quarterly. In addition, a facility fee of .15% per year is charged on the aggregate amount of the credit agreement facility and is payable quarterly. The weighted-average interest rate on the term loan outstanding at December 31, 1997 and 1996, respectively, was 6.1% and 6.3%. The weighted-average interest rate on the revolving credit facility borrowings outstanding at December 31, 1997, was 8.5%. Year-end revolving credit borrowings were made under the base rate (prime rate) option and were converted to lower Eurodollar-based and competitive bid borrowings in early January 1998.

The Credit Agreement contains various financial and operating covenants which require, among other things, the maintenance of certain financial ratios including interest and rent coverage, fixed-charge coverage and senior indebtedness to earnings before interest, income taxes, depreciation and amortization. The Credit Agreement also contains various covenants which, among other things, (a) limit the Company's ability to incur or guarantee indebtedness or other liabilities other than under the Credit Agreement, (b) restrict the Company's ability to engage in asset sales and sale/leaseback transactions, (c) restrict the types of investments the Company can make and (d) restrict the Company's ability to pay cash dividends, redeem or prepay principal and interest on any subordinated debt and certain senior debt.

Commercial Paper

The Company has a facility that provides for the issuance of up to $400 million in commercial paper. At December 31, 1997 and 1996, $350 million and $300 million of the respective $398,744,000 and $398,055,000 outstanding principal amounts, net of discount, was classified as long-term debt since the Company intends to maintain at least this amount outstanding during the next year. Such debt is unsecured and is fully and unconditionally guaranteed by IY. IY has agreed to continue its guarantee of all commercial paper issued through 1999. While it is not anticipated that IY would be required to perform under its commercial paper guarantee, in the event IY makes any payments under the guarantee, the Company and IY have entered into an agreement by which the Company is required to reimburse IY subject to restrictions in the Credit Agreement. The weighted-average interest rate on commercial paper borrowings outstanding at December 31, 1997 and 1996, respectively, was 5.8% and 5.4%.

Debentures

The Debentures are accounted for in accordance with SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructuring," and were recorded at an amount equal to the future undiscounted cash payments, both principal and interest ("SFAS No. 15 Interest"). Accordingly, no interest expense will be recognized over the life of these securities, and cash interest payments will be charged against the recorded amount of such securities. Interest on all of the Debentures is payable in cash semiannually on June 15 and December 15 of each year.

The 5% First Priority Senior Subordinated Debentures, due December 15, 2003, had an outstanding principal amount of $269,993,000 at December 31, 1997, and are redeemable at any time at the Company's option at 100% of the principal amount.

The Second Priority Senior Subordinated Debentures were issued in three series, and each series is redeemable at any time at the Company's option at 100% of the principal amount and are described as follows:

- 4½% Series A Debentures, due June 15, 2004, with an outstanding principal amount of $123,654,000 at December 31, 1997.
- 4% Series B Debentures, due June 15, 2004, with an outstanding principal amount of $18,766,000 at December 31, 1997.
- 12% Series C Debentures, due June 15, 2009 ("12% Debentures"), with an outstanding principal amount of $21,787,000 at December 31, 1997.

In November 1995, the Company purchased $180,621,000 of the principal amount of its First Priority Senior Subordinated Debentures due 2003 ("5% Debentures") and $82,719,000 of the principal amount of its 4½% Second Priority Senior Subordinated Debentures (Series A) due 2004 ("4½% Debentures") (collectively, "Refinanced Debentures") with a portion of the proceeds from the issuance of $300 million principal amount of Convertible Quarterly Income Debt Securities (see Note 9). The purchase of the Refinanced Debentures resulted in an extraordinary gain of $103,169,000 (net of tax effect of $8,603,000) as a result of the discounted purchase price and the inclusion of SFAS No. 15 Interest in the carrying amount of the debt.

Prior to the refinancing, the 5% Debentures were subject to annual sinking fund requirements of $27,045,000 due each December 15, commencing 1996 through 2002. The Company used its purchase of the 5% Debentures to satisfy such sinking fund requirements in direct order of maturity until December 15, 2002, at which time a sinking fund payment of $8,696,000 will be due.

The Debentures contain certain covenants that, among other things, (a) limit the payment of dividends and certain other restricted payments by both the Company and its subsidiaries, (b) require the purchase by the Company of the Debentures at the option of the holder upon a change of control, (c) limit additional indebtedness, (d) limit future

exchange offers, (e) limit the repayment of subordinated indebtedness, (f) require board approval of certain asset sales, (g) limit transactions with certain stockholders and affiliates and (h) limit consolidations, mergers and the conveyance of all or substantially all of the Company's assets.

The First and Second Priority Senior Subordinated Debentures are subordinate to the borrowings outstanding under the Credit Agreement and to previously outstanding mortgages and notes that are either backed by specific collateral or are general unsecured, unsubordinated obligations. The Second Priority Debentures are subordinate to the First Priority Debentures.

Yen Loan

In March 1988, the Company monetized its future royalty payments from SEJ, its area licensee in Japan, through a loan that is nonrecourse to the Company as to principal and interest. The original amount of the yen-denominated debt was 41 billion yen (approximately $327,000,000 at the exchange rate in March 1988) and is collateralized by the Japanese trademarks and a pledge of the future royalty payments. By designating its future royalty receipts during the term of the loan to service the monthly interest and principal payments, the Company has hedged the impact of future exchange rate fluctuations. Payment of the debt is required no later than March 2006 through future royalties from the Japanese licensee. The Company believes it is a remote possibility that there will be any principal balance remaining at that date because current royalty projections suggest the Yen Loan could be repaid as early as 2001. Upon the later of February 28, 2000, or the date which is one year following the final repayment of the loan, royalty payments from the area licensee in Japan will be reduced by approximately two-thirds in accordance with the terms of the license agreement. The current interest rate of 6¼% will be reset before the end of March 1998 to a rate that is .5% in excess of the Japanese long-term lending rate, which was 2.3% as of December 31, 1997. The Company anticipates that the new rate will be lower than the current rate.

Cityplace Debt

Cityplace Center East Corporation ("CCEC"), a subsidiary of the Company, constructed the headquarters tower, parking garages and related facilities of the Cityplace Center development and is currently obligated to The Sanwa Bank, Limited, Dallas Agency ("Sanwa"), which has a lien on the property financed. The debt with Sanwa has monthly payments of principal and interest based on a 25-year amortization at 7½%, with the remaining principal due on March 1, 2005 (the "Cityplace Term Loan").

The Company is occupying part of the building as its corporate headquarters and the balance is subleased. As additional consideration through the extended term of the debt, CCEC will pay to Sanwa an amount that it receives from the Company which is equal to the net sublease income that the Company receives on the property and 60% of the proceeds, less $275 million and permitted costs, upon a sale or refinancing of the building.

Maturities

Long-term debt maturities assume the continuance of the commercial paper program. The maturities, which include capital lease obligations and sinking fund requirements, as well as SFAS No. 15 Interest accounted for in the recorded amount of the Debentures, are as follows (dollars in thousands):

1998	$ 208,839
1999	155,629
2000	152,659
2001	132,600
2002	51,625
Thereafter	1,102,032
	$ 1,803,384

9. Convertible Quarterly Income Debt Securities Due 2010

In November 1995, the Company issued $300 million principal amount of Convertible Quarterly Income Debt Securities due 2010 ("Convertible Debt") to IY and SEJ. The Company used $216,739,000 of the proceeds to purchase the Refinanced Debentures (see Note 8), and the remaining proceeds were designated for general corporate purposes. The Convertible Debt has an interest rate of 4½% and gives the Company the right to defer interest payments thereon for up to 20 consecutive quarters. The holder of the Convertible Debt can convert it into a maximum of 72,112,000 shares of the Company's common shares. The conversion rate represents a premium to the market value of the Company's common stock at the time of issuance of the Convertible Debt. As of December 31, 1997, no shares had been issued as a result of debt conversion. The Convertible Debt is subordinate to all existing debt.

In addition to the principal amount of the Convertible Debt, the financial statements include interest payable of $563,000 in both 1997 and 1996 and interest expense of $13,733,000, $13,658,000 and $1,332,000 in 1997, 1996 and 1995, respectively, related to the Convertible Debt.

10. Financial Instruments

Fair Value

The disclosure of the estimated fair value of financial instruments has been determined by the Company using available market information and appropriate valuation methodologies as indicated below.

The carrying amounts of cash and cash equivalents, trade accounts receivable, trade accounts payable and accrued expenses and other liabilities are reasonable estimates of their fair values. Letters of credit are included in the estimated fair value of accrued expenses and other liabilities.

The carrying amounts and estimated fair values of other financial instruments at December 31, 1997, are listed in the following table:

(Dollars in Thousands)	Carrying Amount	Estimated Fair Value
Bank Debt	$ 287,000	$ 287,000
Commercial Paper	398,744	398,744
Debentures	585,877	371,138
Yen Loan	168,198	162,973
Cityplace Term Loan	277,926	292,686
Convertible Debt — not practicable to estimate fair value	300,000	—

The methods and assumptions used in estimating the fair value for each of the classes of financial instruments presented in the table above are as follows:

- The carrying amount of the Bank Debt approximates fair value because the interest rates are variable.
- Commercial paper borrowings are sold at market interest rates and have an average remaining maturity of less than 15 days. Therefore, the carrying amount of commercial paper is a reasonable estimate of its fair value. The guarantee of the commercial paper by IY is an integral part of the estimated fair value of the commercial paper borrowings.
- The fair value of the Debentures is estimated based on December 31, 1997, bid prices obtained from investment banking firms where traders regularly make a market for these financial instruments. The carrying amount of the Debentures includes $151,677,000 of SFAS No. 15 Interest.
- The fair value of the Yen Loan is estimated by calculating the present value of the future yen cash flows at current interest and exchange rates.
- The fair value of the Cityplace Term Loan is estimated by calculating the present value of the future cash flows at current interest rates.
- It is not practicable, without incurring excessive costs, to estimate the fair value of the Convertible Debt (see Note 9) at December 31, 1997. The fair value would be the sum of the fair values assigned to both an interest rate and an equity component of the debt by a valuation firm.

Derivatives

The Company is using derivative financial instruments to reduce its exposure to market risk resulting from fluctuations in both foreign exchange rates and interest rates (see Note 17). On December 10, 1997, the Company hedged an anticipated yen-denominated loan to be closed in the second quarter of 1998 by purchasing a put option for 12.5 billion yen from a major financial institution at a strike price of 129.53 yen per dollar. The cost of the put option of $2,131,000 has been treated as deferred loan costs and is recorded in other assets at December 31, 1997. If the anticipated transaction does not close and the exchange rate is below 129.53 yen per dollar, the Company will recognize the $2,131,000 as expense. If the anticipated transaction does not close and the exchange rate is above 129.53 yen per dollar, the Company will receive value for the put, which could offset some or all of the cost of the put and could result in additional income to the Company.

In addition, as part of the transaction, the Company financed the purchase of the put option by selling a call option at a strike price of 125.08 yen per dollar with the same yen amount and maturity as the put option, thereby committing the Company to exchange at a rate of 125.08. The call option is marked to market and had a balance of $1,614,000 included in accrued expenses and other liabilities at December 31, 1997. If the exchange rate appreciates below 125.08, the Company will lose proceeds from the call. If the exchange rate appreciates below 123.09, the Company will recognize expense in 1998.

11. Employee Benefit Plans

Profit Sharing Plans

The Company maintains profit sharing plans for its U.S. and Canadian employees. In 1949, the Company excluding its Canadian subsidiary ("Southland") adopted The Southland Corporation Employees' Savings and Profit Sharing Plan (the "Savings and Profit Sharing Plan") and, in 1970, the Company's Canadian subsidiary adopted the Southland Canada, Inc., Profit Sharing Pension Plan. In 1997, the name of the Canadian plan was changed to the Southland Canada, Inc., Pension Plan. These plans provide retirement benefits to eligible employees.

Contributions to the Savings and Profit Sharing Plan, a 401(k) defined contribution plan, are made by both the participants and Southland. Southland contributes the greater of approximately 10% of its net earnings or an amount determined by Southland's president. Net earnings are calculated without regard to the contribution to the Savings and Profit Sharing Plan, federal income taxes, gains from debt repurchases and refinancings and, at the discretion of Southland's president, income from accounting changes. The contribution by Southland is generally allocated to the participants on the basis of their individual contribution and years of participation in the Savings and Profit Sharing Plan. The provisions of the Southland Canada, Inc., Pension Plan are similar to those of the Savings and Profit Sharing Plan. Total contributions to these plans for the years ended December 31, 1997, 1996 and 1995 were $12,977,000, $14,069,000 and $11,318,000, respectively, and are included in OSG&A.

Supplemental Executive Retirement Plan

Effective January 1, 1998, the Company established The Southland Corporation Supplemental Executive Retirement Plan for Eligible Employees (the "Supplemental Executive Retirement Plan"), which is an unfunded employee pension benefit plan maintained primarily to allow compensation to be deferred by highly compensated employees as defined by the Internal Revenue Service. Benefits under this plan constitute general obligations of the Company, subject to the claims of general creditors of the Company, and participants have no security or other interest in such funds.

Contributions to the Supplemental Executive Retirement Plan, a deferred compensation plan, are made by the participant and may be made by the Company. A participant may elect to defer a maximum of 12 percent of eligible compensation. The Company may make a matching contribution, if so authorized each plan year, up to a maximum of 6 percent of the participant's eligible compensation minus the amount of the participant's deferral to the Savings and Profit Sharing Plan. Matching contributions, if any, will be credited to the participant's account at the same rate that Southland matches under the Savings and Profit Sharing Plan, but using years of service with the Company, minus one, rather than years of participation in the Savings and Profit Sharing Plan to determine a participant's group.

Postretirement Benefits

The Company's group insurance plan (the "Insurance Plan") provides postretirement medical and dental benefits for all retirees that meet certain criteria. Such criteria include continuous participation in the Insurance Plan ranging from 10 to 15 years depending on hire date, and the sum of age plus years of continuous service equal to at least 70. The Company contributes toward the cost of the Insurance Plan a fixed dollar amount per retiree based on age and number of dependents covered, as adjusted for actual claims experience. All other future costs and cost increases will be paid by the retirees. The Company continues to fund its cost on a cash basis; therefore, no plan assets have been accumulated.

Net periodic postretirement benefit costs for 1997, 1996 and 1995 include the following components:

(Dollars in Thousands)	1997	1996	1995
Service cost	$ 521	$ 595	$ 585
Interest cost	1,535	1,496	1,678
Amortization of unrecognized gain	(603)	(498)	(583)
	$ 1,453	$ 1,593	$ 1,680

The weighted-average discount rate used in determining the accumulated postretirement benefit obligation was 7.25% and 7.5% at December 31, 1997 and 1996, respectively. Components of the accrual recorded in the Consolidated Balance Sheets are as follows:

(Dollars in Thousands)

December 31	1997	1996
Accumulated Postretirement		
Benefit Obligation:		
Retirees	$ 10,158	$ 11,174
Active employees eligible to retire	5,866	4,772
Other active employees	5,214	5,251
	21,238	21,197
Unrecognized gains	7,724	7,623
	$ 28,962	$ 28,820

Stock Incentive Plan

The Southland Corporation 1995 Stock Incentive Plan (the "Stock Incentive Plan") was adopted by the Company in October 1995 and approved by the shareholders in April 1996. The Stock Incentive Plan provides for the granting of stock options, stock appreciation rights, performance shares, restricted stock, restricted stock units, bonus stock and other forms of stock-based awards and authorizes the issuance of up to 41 million shares over a 10-year period to certain key employees and officers of the Company. All options granted in 1997, 1996 and 1995 were granted at an exercise price that was equal to the fair market value on the date of grant. The options granted are exercisable in five equal installments beginning one year after grant date with possible acceleration thereafter based upon certain improvements in the price of the Company's common stock.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for the options granted: for each year presented, expected life of five years and no dividend yields, combined with risk-free interest rates of 5.81%, 6.39% and 5.89% in 1997, 1996 and 1995, respectively, and expected volatility of 51.37% in 1997 and 55.49% in both 1996 and 1995.

A summary of the status of the Stock Incentive Plan as of December 31, 1997, 1996 and 1995, and changes during the years ending on those dates, is presented below:

	1997		1996		1995	
Fixed Options	Shares (000's)	Weighted-Average Exercise Price	Shares (000's)	Weighted-Average Exercise Price	Shares (000's)	Weighted-Average Exercise Price
Outstanding at beginning of year	7,618	$ 3.0895	3,864	$ 3.1875	—	—
Granted	3,390	2.4690	3,978	3.0000	3,864	$ 3.1875
Exercised	—	—	—	—	—	—
Forfeited	(508)	3.0679	(224)	3.1875	—	—
Outstanding at end of year	10,500	$ 2.8903	7,618	$ 3.0895	3,864	$ 3.1875
Options exercisable at year-end	2,126	$ 3.1231	728	$ 3.1875	—	—
Weighted-average fair value of options granted during the year	$ 1.2691		$ 1.6413		$ 1.7243	

Options Outstanding				Options Exercisable	
Range of Exercise Prices	Options Outstanding at 12/31/97	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Options Exercisable at 12/31/97	Weighted-Average Exercise Price
$ 2.4690	3,389,500	9.87	$ 2.4690	—	—
3.0000	3,653,940	8.75	3.0000	730,788	$3.0000
3.1875	3,456,360	7.81	3.1875	1,395,420	3.1875
2.4690-3.1875	10,499,800	8.80	2.8903	2,126,208	3.1231

The Company is accounting for the Stock Incentive Plan under the provisions of APB No. 25 (see Note 1) and, accordingly, no compensation cost has been recognized. If compensation cost had been determined based on the fair value at the grant date for awards under this plan consistent with the method prescribed by SFAS No. 123, the

Company's net earnings and earnings per share for the years ended December 31, 1997, 1996 and 1995, would have been reduced to the pro forma amounts indicated in the table below:

(Dollars in Thousands, Except Per-Share Data)	1997	1996	1995
Net earnings:			
As reported	$ 70,042	$ 89,476	$ 270,763
Pro forma	68,542	88,520	270,610
Earnings per common share:			
As reported			
Basic	$ .17	$ .22	$ .66
Diluted	.16	.20	.65
Pro forma			
Basic	$ .17	$ .22	$ .66
Diluted	.16	.20	.65

Equity Participation Plan

In 1988, the Company adopted The Southland Corporation Equity Participation Plan (the "Participation Plan"), which provided for the granting of both incentive options and nonstatutory options and the sale of convertible debentures to certain key employees and officers of the Company. In the aggregate, not more than 3,529,412 shares of common stock of the Company were authorized for issuance pursuant to the Participation Plan.

Options were granted at the fair market value on the date of grant, which was the same as the conversion price provided in the debentures. All options and convertible debentures that were vested became exercisable as of December 31, 1994. As of December 31, 1997, no shares had been issued, and the right to exercise all outstanding options and convertible debentures expired. Pursuant to its terms, the Participation Plan terminated on that date.

Grant Stock Plan

In 1988, the Company adopted The Southland Corporation Grant Stock Plan (the "Stock Plan"). Under the provisions of the Stock Plan, up to 750,000 shares of common stock are authorized to be issued to certain key employees and officers of the Company. The stock is fully vested upon the date of issuance. As of December 31, 1997, 480,844 shares had been issued pursuant to the Stock Plan. No shares have been issued since 1988, and the Company has no present intent to grant additional shares.

12. Leases

Leases

Certain property and equipment used in the Company's business is leased. Generally, real estate leases are for primary terms from 14 to 20 years with options to renew for additional periods, and equipment leases are for terms from one to 10 years. The leases do not contain restrictions that have a material effect on the Company's operations.

In April 1997, the Company obtained commitments from the same group of lenders that participated in the Credit Agreement (see Note 8) for up to $115 million of lease financing to be used primarily for electronic point-of-sale equipment associated with the Company's retail information system. On October 1, 1997, the Company received $41,406,000 of the available funding under the master lease facility and intends to use the remainder of the funding as the system roll-out continues. Lease payments are variable based on changes in LIBOR.

Individual leases under this master lease facility have initial terms that expire on June 30, 2000, at which time the Company has an option to cancel all leases under this facility by purchasing the equipment or arranging its sale to a third party. The Company also has the option to renew the leases semiannually until five years after the beginning of the individual leases. At each semiannual renewal date, the Company has the option to purchase the equipment and end the lease. Individual leases may be extended beyond five years through an extended rental agreement.

The composition of capital leases reflected as property and equipment in the Consolidated Balance Sheets is as follows:

(Dollars in Thousands) **December 31**	1997	1996
Buildings	$ 111,946	$ 106,358
Equipment	43,115	142
	155,061	106,500
Accumulated amortization	(72,059)	(71,019)
	$ 83,002	$ 35,481

The present value of future minimum lease payments for capital lease obligations is reflected in the Consolidated Balance Sheets as long-term debt. The amount representing imputed interest necessary to reduce net minimum lease payments to present value has been calculated generally at the Company's incremental borrowing rate at the inception of each lease.

Future minimum lease payments for years ending December 31 are as follows:

(Dollars in Thousands)	Capital Leases	Operating Leases
1998	$ 31,890	$ 117,568
1999	29,976	95,955
2000	27,332	77,962
2001	24,618	63,157
2002	14,894	47,257
Thereafter	57,629	160,496
Future minimum lease payments	186,339	$ 562,395
Estimated executory costs	(136)	
Amount representing imputed interest	(60,426)	
Present value of future minimum lease payments	$ 125,777	

Minimum noncancelable sublease rental income to be received in the future, which is not included above as an offset to future payments, totals $16,265,000 for capital leases and $13,427,000 for operating leases.

Rent expense on operating leases for the years ended December 31, 1997, 1996 and 1995, totaled $136,516,000, $132,760,000 and $125,456,000, respectively, including contingent rent expense of $9,360,000, $9,438,000 and $8,508,000, but reduced by sublease rent income of $6,620,000, $7,175,000 and $7,296,000. Contingent rent expense on capital leases for the years ended December 31, 1997, 1996 and 1995, was $1,987,000, $2,088,000 and $2,399,000, respectively. Contingent rent expense is generally based on sales levels or changes in the Consumer Price Index.

Leases with the Savings and Profit Sharing Plan

At December 31, 1997, the Savings and Profit Sharing Plan owned 99 stores leased to the Company under capital leases and 629 stores leased to the Company under operating leases at rentals which, in the opinion of management, approximated market rates at the date of lease. In addition, in 1997, 1996 and 1995, there were 64, 38 and 67 leases, respectively, that either expired or, as a result of properties that were sold by the Savings and Profit Sharing Plan to third parties, were canceled or assigned to the new owner. Also, one property was sold to the Company by the Savings and Profit Sharing Plan in 1997. Included in the consolidated financial statements are the following amounts related to leases with the Savings and Profit Sharing Plan:

(Dollars in Thousands) **December 31**	**1997**	**1996**
Buildings (net of accumulated amortization of $4,830 and $6,718)	$ 513	$ 1,144
Capital lease obligations (net of current portion of $709 and $1,200)	$ 321	$ 1,055

(Dollars in Thousands) **Years Ended December 31**	**1997**	**1996**	**1995**
Rent expense under operating leases and amortization of capital lease assets	$ 23,961	$ 25,670	$ 26,850
Imputed interest expense on capital lease obligations	$ 159	$ 299	$ 483
Capital lease principal payments included in principal payments under long-term debt agreements	$ 1,183	$ 1,580	$ 1,818

13. Commitments and Contingencies

McLane Company, Inc.

In connection with the 1992 sale of distribution and food center assets to McLane, the Company and McLane entered into a 10-year service agreement under which McLane is making its distribution services available to 7-Eleven stores in the United States. If the Company does not fulfill its obligation to McLane during this time period, the Company must reimburse McLane on a pro-rata basis for the transitional payment received at the time of

the transaction. The original payment received of $9,450,000 in 1992 is being amortized to cost of goods sold over the life of the agreement. The Company has exceeded the minimum annual purchases each year and expects to exceed the minimum required purchase levels in future years.

Citgo Petroleum Corporation

In 1986, the Company entered into a 20-year product purchase agreement with Citgo to buy specified quantities of gasoline at market prices. These prices are determined pursuant to a formula based on the prices posted by gasoline wholesalers in the various market areas where the Company purchases gasoline from Citgo. Minimum required annual purchases under this agreement are generally the lesser of 750 million gallons or 35% of gasoline purchased by the Company for retail sale. The Company has exceeded the minimum required annual purchases each year and expects to exceed the minimum required annual purchase levels in future years.

Environmental

In December 1988, the Company closed its chemical manufacturing facility in New Jersey. As a result, the Company is required to conduct environmental remediation at the facility and has submitted a clean-up plan to the New Jersey Department of Environmental Protection (the "State"), which provides for active remediation of the site for approximately a three-to-five-year period, as well as continued groundwater monitoring and treatment for a projected 15-year period approved by the State. The Company has received conditional approval of its clean-up plan. The projected 15-year clean-up period represents a reduction from the previously reported 20-year period and is a result of revised estimates as determined by an independent environmental management company in the first quarter of 1997. These revised estimates, which generally resulted from the conditional approval of the Company's plan, reduced both the estimated time and the estimated costs to complete the project and resulted in decreasing the liability and the related receivable balances by $16.3 million and $9.7 million, respectively. The Company has recorded undiscounted liabilities representing its best estimates of the clean-up costs of $10,442,000 and $30,900,000 at December 31, 1997 and 1996, respectively. Of this amount, $8,624,000 and $25,246,000 are included in deferred credits and other liabilities and the remainder in accrued expenses and other liabilities for the respective years.

In 1991, the Company and the former owner of the facility executed a final settlement pursuant to which the former owner agreed to pay a substantial portion of the clean-up costs. Based on the terms of the settlement agreement and the financial resources of the former owner, the Company has recorded receivable amounts of $6,126,000 and $18,227,000 at December 31, 1997 and 1996, respectively. Of this amount, $4,907,000 and $14,861,000 are included in other assets and the remainder in accounts receivable for 1997 and 1996, respectively.

Additionally, the Company accrues for the anticipated future costs and the related probable state reimbursement amounts for remediation activities at its existing and previously operated gasoline store sites where releases of regulated substances have been detected. At December 31, 1997 and 1996, respectively, the Company's estimated undiscounted liability for these sites was $40,880,000 and $46,508,000, of which $22,880,000 and $28,508,000 are included in deferred credits and other liabilities and the remainder is included in accrued expenses and other liabilities. These estimates were based on the Company's prior experience with gasoline sites and its consideration of such factors as the age of the tanks, location of tank sites and experience with contractors who perform environmental assessment and remediation work. The Company anticipates that substantially all of the future remediation costs for detected releases at these sites as of December 31, 1997, will be incurred within the next five years.

Under state reimbursement programs, the Company is eligible to receive reimbursement for a portion of future remediation costs, as well as a portion of remediation costs previously paid. Accordingly, the Company has recorded net receivable amounts of $44,809,000 and $50,025,000 for the estimated probable state reimbursements, of which $33,809,000 and $39,025,000 are included in other assets and the remainder in accounts receivable for 1997 and 1996, respectively. The Company increased the estimated net environmental cost reimbursements at the end of 1996 by approximately $7,500,000 as a result of completing a review of state reimbursement programs. In assessing the probability of state reimbursements, the Company takes into consideration each state's fund balance, revenue sources, existing claim backlog, status of clean-up activity and claim ranking systems. As a result of these assessments, the recorded receivable amounts in other assets are net of allowances of $9,704,000 and $9,459,000 for 1997 and 1996, respectively. While there is no assurance of the timing of the receipt of state reimbursement funds, based on the Company's experience, the Company expects to receive the majority of state reimbursement funds, except from California, within one to three years after payment of eligible remediation expenses, assuming that the state administrative procedures for processing such reimbursements have been fully developed. The Company estimates that it may take one to seven years to receive reimbursement funds from California. Therefore, the portion of the recorded receivable amounts that relate to sites where remediation activities have been conducted has been discounted at 5.7% and 7% in 1997 and 1996, respectively, to reflect its present value. The 1997 and 1996 recorded receivable amounts are net of discounts of $6,048,000 and $6,398,000, respectively.

The estimated future remediation expenditures and related state reimbursement amounts could change within the near future as governmental requirements and state reimbursement programs continue to be implemented or revised.

14. Income Taxes

The components of earnings before income taxes and extraordinary gain are as follows:

(Dollars in Thousands)

Years Ended December 31	1997	1996	1995
Domestic (including royalties of $67,259, $63,536 and $59,044 from area license agreements in foreign countries)	$ 109,982	$ 124,316	$ 98,775
Foreign	5,313	6,508	2,754
	$ 115,295	$ 130,824	$ 101,529

The provision for income taxes in the accompanying Consolidated Statements of Earnings consists of the following:

(Dollars in Thousands)

Years Ended December 31	1997	1996	1995
Current:			
Federal	$ 1,182	$ 5,054	$ 8,251
Foreign	11,559	10,704	8,968
State	700	1,800	985
Subtotal	13,441	17,558	18,204
Deferred:			
Provision	31,812	23,790	60,709
Beginning of year valuation allowance adjustment	—	—	(144,978)
Subtotal	31,812	23,790	(84,269)
Income taxes (benefit) before extraordinary gain	$ 45,253	$ 41,348	$ (66,065)

Included in the accompanying Consolidated Statements of Shareholders' Equity (Deficit) at December 31, 1997 and 1996, respectively, are $5,870,000 and $6,882,000 of income taxes provided on unrealized gains on marketable securities.

Reconciliations of income taxes (benefit) before extraordinary gain at the federal statutory rate to the Company's actual income taxes provided are as follows:

(Dollars in Thousands)

Years Ended December 31	1997	1996	1995
Taxes at federal statutory rate	$ 40,353	$ 45,788	$ 35,535
State income taxes, net of federal income tax benefit	455	1,170	640
Foreign tax rate difference	2,095	1,077	886
Net change in valuation allowance excluding the tax effect of the 1995 extraordinary item	—	—	(108,632)
Settlement of IRS examination	—	(7,261)	—
Other	2,350	574	5,506
	$ 45,253	$ 41,348	$ (66,065)

The valuation allowance for deferred tax assets decreased in 1995 by $174,589,000. The decrease consisted of a $90,320,000 decrease resulting from changes in the Company's gross deferred tax assets and liabilities and an $84,269,000 decrease resulting from a change in estimate regarding the realizability of the Company's deferred tax assets. Based on the Company's trend of positive earnings from 1993 through 1995 and future expectations, the Company determined that it was more likely than not that its deferred tax assets would be fully realized.

Significant components of the Company's deferred tax assets and liabilities are as follows:

(Dollars in Thousands) **December 31**	**1997**	**1996**
Deferred tax assets:		
SFAS No. 15 interest	$ 65,559	$ 75,037
Compensation and benefits	40,729	42,573
Accrued insurance	33,838	39,494
Accrued liabilities	25,980	35,677
Tax credit carryforwards	13,981	8,924
Debt issuance costs	6,777	8,059
Other	6,312	5,056
Subtotal	193,176	214,820
Deferred tax liabilities:		
Area license agreements	(70,459)	(77,811)
Property and equipment	(61,687)	(41,636)
Other	(10,791)	(11,777)
Subtotal	(142,937)	(131,224)
Net deferred taxes	$ 50,239	$ 83,596

At December 31, 1997, the Company's net deferred tax asset is recorded in other current assets (see Note 4) and deferred credits and other liabilities. At December 31, 1996, the Company's net deferred tax asset is recorded in other current assets and other assets (see Notes 4 and 6).

At December 31, 1997, the Company had approximately $12,200,000 of alternative minimum tax ("AMT") credit carryforwards and $1,700,000 of foreign tax credit carryforwards. The AMT credits have no expiration date and the foreign tax credits expire in 2002.

15. Earnings Per Common Share

The Company adopted SFAS No. 128, "Earnings per Share," in December 1997. This statement, which replaces APB Opinion No. 15, "Earnings per Share," establishes simplified accounting standards for computing earnings per share ("EPS") and makes them comparable to international EPS standards.

Basic EPS is computed by dividing net earnings by the weighted-average number of common shares outstanding during each year. Diluted EPS is computed by dividing net earnings, plus interest on Convertible Debt (see Note 9) net of tax benefits, by the sum of the weighted-average number of common shares outstanding, the weighted-average number of common shares associated with the Convertible Debt and the dilutive effects of the stock options outstanding (see Note 11) during each year. All prior-period EPS amounts presented have been restated to conform to the provisions of SFAS No. 128.

A reconciliation of the numerators and the denominators of the basic and diluted per-share computations for net earnings, as required by SFAS No. 128, is presented below:

(Dollars in Thousands) **Years Ended December 31**	**1997**	**1996**	**1995**
Basic EPS Computation:			
Earnings (Numerator)			
Net earnings	$ 70,042	$ 89,476	$ 270,763
Earnings available to common shareholders	70,042	89,476	270,763
Shares (Denominator)			
Weighted-average number of common shares outstanding	409,923	409,923	409,923
Basic EPS	$ .17	$ .22	$ .66
Diluted EPS Computation:			
Earnings (Numerator)			
Earnings available to common shareholders	$ 70,042	$ 89,476	$ 270,763
Add interest on Convertible Debt, net of tax	8,343	8,297	1,093
Earnings available to common shareholders plus assumed conversions	78,385	97,773	271,856
Shares (Denominator)			
Weighted-average number of common shares outstanding	409,923	409,923	409,923
Add effects of assumed conversions:			
Exercise of stock options	170	167	45
Conversion of Convertible Debt	72,112	72,112	6,811
Weighted-average number of common shares outstanding plus shares from assumed conversions	482,205	482,202	416,779
Diluted EPS	$ .16	$ .20	$ .65

16. Preferred Stock

The Company has 5,000,000 shares of preferred stock authorized for issuance. Any preferred stock issued will have such rights, powers and preferences as determined by the Company's Board of Directors.

17. Subsequent Events

Legal Settlement

The Company is a defendant in two legal actions, which are referred to as the 7-Eleven OFFF and Valente cases, filed by franchisees in 1993 and 1996, respectively, asserting various claims against the Company. A nationwide settlement has recently been negotiated and, in connection with the settlement, these two cases have been combined on behalf of a class of all persons who operated 7-Eleven convenience stores in the continental United States at any time between January 1, 1987 and July 31, 1997, under franchise agreements with the Company. In January 1998, a notice was mailed to the class members summarizing the terms of the proposed settlement. Class members have until March 31, 1998, to opt out of the settlement. A final hearing to approve the settlement is scheduled for April 24, 1998. The Company's accruals are sufficient to cover the $11,750,000 payment due under the settlement, and there was no material impact in 1997.

Financing/Call of Debentures

On February 26, 1998, the Company issued $80 million principal amount of Convertible Quarterly Income Debt Securities due 2013 ("1998 QUIDS") to IY and SEJ. The Company intends to use the proceeds primarily to repurchase a portion of its outstanding Debentures, and on February 27, 1998, the Company issued a 30-day call for the redemption of the remaining $21,787,000 principal amount of its 12% Debentures at 100% of the principal amount together with the related accrued interest.

The 1998 QUIDS have an interest rate of 4½%, and the Company has the right to defer interest payments for up to 20 consecutive quarters. After three years, the 1998 QUIDS have a mandatory conversion feature when certain conditions are met with regard to the Company's closing common stock price. If such conditions are met, the 1998 QUIDS are convertible into 32,508,000 shares of the Company's common shares, which was derived by dividing $80 million by the Company's closing common stock price on the date prior to their issuance plus a conversion premium of 25%. The 1998 QUIDS are subordinate to all existing debt, except they are equivalent to the Convertible Debt (see Note 9).

Interest Rate Swap

On March 12, 1998, the Company entered into a forward starting interest rate swap hedge agreement that fixes the interest rate at 2.325% on an anticipated 12.5 billion yen floating rate loan, which is expected to be funded around the end of April 1998. The Company would be at risk of loss if the anticipated transaction does not close and Japanese interest rates decline. If the loan does not close, the hedge will unwind by the end of June 1998.

18. Quarterly Financial Data (Unaudited)

Summarized quarterly financial data for 1997 and 1996 is as follows:

(Dollars in Millions, Except Per-Share Data) **Year Ended December 31, 1997**	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Net sales	$ 1,604	$ 1,782	$ 1,874	$ 1,711	$ 6,971
Gross profit	450	522	552	488	2,012
Income taxes	4	17	22	2	45
Net earnings	6	26	33	5	70
Earnings per common share:					
Basic	.01	.06	.08	.01	.17
Diluted	.01	.06	.07	.01	.16
Year Ended December 31, 1996					
Net sales	$ 1,563	$ 1,792	$ 1,840	$ 1,674	$ 6,869
Gross profit	442	525	541	468	1,976
Income taxes (benefit)	4	20	25	(8)	41
Net earnings	5	30	38	16	89
Earnings per common share:					
Basic	.01	.07	.09	.04	.22
Diluted	.01	.07	.08	.04	.20

To the Board of Directors and Shareholders of
The Southland Corporation
Dallas, Texas

We have audited the accompanying consolidated balance sheets of The Southland Corporation and Subsidiaries as of December 31, 1997 and 1996, and the related consolidated statements of earnings, shareholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of The Southland Corporation and Subsidiaries as of December 31, 1997 and 1996, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1997 in conformity with generally accepted accounting principles.

Coopers & Lybrand L.L.P.

Dallas, Texas
February 5, 1998, except as to items 2 and 3 in Note 17,
for which the date is March 12, 1998.

Directors

Masatoshi Ito
Chairman of the Board;
Director, Honorary Chairman,
Ito-Yokado Group

Toshifumi Suzuki (1)
Vice Chairman of the Board;
President and Chief Executive Officer,
Ito-Yokado Co., Ltd.;
Chairman and Chief Executive Officer,
Seven-Eleven Japan Co., Ltd.

Clark J. Matthews, II
President and
Chief Executive Officer;
Secretary,
The Southland Corporation

James W. Keyes
Executive Vice President
and Chief Financial Officer,
The Southland Corporation

Stephen B. Krumholz (3)
Executive Vice President
and Chief Operating Officer,
The Southland Corporation

Masaaki Asakura
Vice President,
The Southland Corporation

Yoshitami Arai
Chairman of the Board,
Systems International Incorporated

Timothy Ashida
President,
A.K.K. Associates, Inc.

Jay W. Chai (2)
Chairman of the Board and
Chief Executive Officer,
ITOCHU International Inc.

Gary J. Fernandes (1) (2)
Vice Chairman,
Electronic Data Systems Corporation

Masaaki Kamata
Director and
Executive Vice President,
Seven-Eleven Japan Co., Ltd.

Kazuo Otsuka (1)
General Manager,
Corporate Development,
Ito-Yokado Co., Ltd.

Asher O. Pacholder (2)
Chairman of the Board
and Chief Financial Officer,
ICO, Inc.

Nobutake Sato
Chief Financial Officer,
Ito-Yokado Co., Ltd.

(1) Compensation and Benefits Committee
(2) Audit Committee
(3) Resigned effective February 23, 1998

Officers

Masatoshi Ito
Chairman of the Board

Toshifumi Suzuki
Vice Chairman of the Board

Clark J. Matthews, II
President and Chief Executive Officer;
Secretary

James W. Keyes
Executive Vice President
and Chief Financial Officer

Stephen B. Krumholz (3)
Executive Vice President
and Chief Operating Officer

Rodney A. Brehm
Senior Vice President,
Southwest Division

Stephen B. Leroy
Senior Vice President,
International and Real Estate

Bryan F. Smith, Jr.
Senior Vice President and
General Counsel

Masaaki Asakura
Vice President

Robert E. Bailey
Vice President

Wendy Barth
Vice President,
Sales and Marketing

Terry Blocher
Vice President,
Human Resources

Steve Brune
Vice President,
Northwest Division

Paul L. Bureau, Jr.
Vice President,
Corporate Tax

Frank Crivello
Vice President,
Northeast Division

Cynthia Davis
Vice President,
Central Division

Krista Fuller
Vice President,
Construction and Maintenance

Joseph F. Gomes
Vice President,
Logistics

John W. Harris
Vice President,
Chesapeake Division

Nathan D. Potts
Vice President,
Foods Merchandising

Sharon Powell
Vice President,
Florida Division

Gary R. Rose
Vice President,
Non-Foods Merchandising

Jeffrey A. Schenck
Vice President,
Greater Midwest Division

Linda Svehlak
Vice President,
Information Systems

Donald E. Thomas
Vice President and Controller

David A. Urbel
Vice President and Treasurer

Corporate Headquarters

The Southland Corporation
2711 North Haskell Ave.
Dallas, TX 75204-2906
(214) 828-7011

Mailing Address:
P.O. Box 711
Dallas, TX 75221-0711

Form 10-K and Other Investor Information

Requests for the Form 10-K for the year ended December 31, 1997, and quarterly financial information should be addressed to the Investor Relations Department at the above address, or telephone (214) 828-7587.

Annual reports are mailed to all shareholders of record. Investors may receive quarterly information regularly by requesting to be included on the company's mailing list.

A recorded company update can be reached and requests for information can be left 24 hours a day by calling (214) 828-7587.

Annual Meeting

The annual meeting will be held at 9:30 a.m. CDT on Wednesday, April 22, 1998, in the Cityplace Conference Center at the company's headquarters. All shareholders and bondholders are cordially invited to attend.

Auditors

Coopers & Lybrand L.L.P.
Dallas, Texas

Common Stock

Southland's common stock is traded on The Nasdaq Stock Market under the ticker symbol SLCM. There were 2,686 shareholders of record as of March 6, 1998.

The company pays no dividends on its common equity as such payments are restricted by the indentures governing its outstanding securities and by Southland's Credit Agreement with its senior lenders.

The table below sets forth the high, low and closing market prices for the periods indicated as provided by Nasdaq.

Price Range:	1997			1996		
Quarters	High	Low	Close	High	Low	Close
First	$ 3 9/16	$ 2 21/32	$ 3 5/32	$ 4 1/16	$ 2 15/16	$ 3 5/16
Second	3 11/16	3 1/8	3 11/32	4 15/16	3	3 1/32
Third	3 13/32	2 1/8	2 9/16	3 5/8	3	3 1/32
Fourth	2 7/8	1 23/32	2 1/8	3 5/32	2 7/16	2 31/32

Common Stock Transfer Agent/Registrar

Harris Trust and Savings Bank
77 Water Street, 4th Floor
New York, NY 10005
(212) 701-7681
(800) 926-1269

Other Securities

The following other Southland securities are traded over the counter, and price information is available by calling the company's recorded message at (214) 828-7587:

5% First Priority Senior Subordinated Debentures
Trustee: Mellon Bank, F.S.B.
Two Mellon Bank Center, Room 325
Pittsburgh, PA 15259-0001

4½% Second Priority Senior Subordinated Debentures (Series A)
4% Second Priority Senior Subordinated Debentures (Series B)
12% Second Priority Senior Subordinated Debentures (Series C)
Trustee: The Bank of New York
101 Barclay Street, Floor 21 West
New York, NY 10286

United States:

Franchised	2,868
Company-operated	2,088

Canada:

Company-operated	467
	5,423

Licensed or Operated by Affiliates

Japan	7,192
Taiwan	1,589
Thailand	901
United States	472
Hong Kong	334
Mexico	227
South Korea	165
Australia	161
Malaysia	141
Philippines	134
Singapore	84
United Kingdom	57
China	44
Sweden	44
Norway	43
Denmark	30
Spain	21
Brazil	13
Puerto Rico	12
Turkey	9
Guam	8
	11,681
7-Eleven Worldwide	17,104

State/Province	Stores	Retail	Total
United States:			
Arizona	95	0	95
California	1,165	3	1,168
Colorado	236	0	236
Connecticut	38	0	38
Delaware	27	0	27
District of Columbia	18	0	18
Florida	425	0	425
Idaho	14	0	14
Illinois	138	5	143
Indiana	16	2	18
Kansas	16	0	16
Maryland	314	0	314
Massachusetts	35	1	36
Michigan	103	0	103
Missouri	81	2	83
Nevada	190	0	190
New Hampshire	9	0	9
New Jersey	203	0	203
New York	235	0	235
North Carolina	7	0	7
Ohio	15	0	15
Oregon	132	0	132
Pennsylvania	166	0	166
Rhode Island	8	0	8
Texas	285	2	287
Utah	112	0	112
Virginia	597	5	602
Washington	218	0	218
West Virginia	23	0	23
Wisconsin	15	0	15
Canada:			
Alberta	120	0	120
British Columbia	146	0	146
Manitoba	50	0	50
Ontario	110	0	110
Saskatchewan	41	0	41
Total	5,403	20	5,423

All numbers as of December 31, 1997

Oh Thank Heaven.™

The Southland Corporation ▪ 2711 North Haskell Avenue ▪ Dallas, Texas 75204-2906 ▪ (214) 828-7011